

**FINANCING CONTINUING CARE RETIREMENT COMMUNITIES:
ALTERNATIVES FOR PROPRIETARY DEVELOPERS**

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Abstract

Continuing care retirement communities house seniors with high levels of service including nursing care. This thesis examines the factors that make development of continuing care communities (CCRC's) difficult, and concentrates especially on the challenges of structuring financing for proprietary CCRC's. After surveying these issues as they apply to the product type in general, the thesis presents a case study of a project under development, and draws conclusions on financial structuring from this empirical analysis. The following sections correspond to the chapters:

2. A demographic overview raises several market-based constraints---and opportunities. Seniors are the fastest growing segment of the U.S. population but are relatively small in number now. The target market is delineated by age (residents are mostly over 75); by gender and marital status (most, but not all, residents are unmarried women); and by physical health. Affordability also limits the market, but is mitigated by the ability to spend high proportions of income on the CCRC housing, and by the use of home equity. Low mobility rates mean that effective capture rates are a low proportion of the qualified market.

3. Development of CCRC's is difficult for many non-financing reasons as well as financing reasons. The former are manifold: the product involves complex configurations of housing and services; state regulations prescribe specific procedures regarding CCRC housing as well as nursing centers; development costs must include high physical plant and marketing expenditures; and operating costs must reflect high service levels, slow community maturation, and sometimes the risk of unpredictable refund and nursing care liabilities.

4. Financing difficulty reflects complex retail fee structures and limitations on debt sources for proprietary projects. There are three main fee structures: the entrance-fee structure, condominium or cooperative ownership, and the all-rental structure. Each has varying impacts on cost, marketing, project financing, management control, and other issues. Permanent debt may depend on the fee structure, but in general it is difficult to obtain project financing for CCRC's. Conventional mortgage financing is problematic in part because of availability and equity requirements; bond financing (although common for congregate housing for the elderly) is difficult to use with CCRC's.

5. "Ashford," the case study project, is a proprietary joint-venture in metropolitan Boston. It will have 300 living units and a 60-bed nursing center. State regulation necessitated the guarantee of unlimited nursing care, and has also influenced the tentative choice of cooperative ownership as the fee structure. Ashford has four distinct profit centers which can potentially benefit the developer (not counting fees), two of which also include the risk of future liability. Startup revenue comes from the gross margin at initial sell-out. Residential operating profit comes primarily from monthly fees. Resale profit occurs when the developer resells units; resale operations constitute a significant risk because deflation or slow resale of units may cause a shortfall of cash available for refunds when a resident dies or leaves. By not guaranteeing refunds, the developer mitigates this risk, but does not obviate the need to establish project reserves to cover such liability. The fourth profit

center, nursing operations, also includes a liability by subsidizing nursing care for residents, for which reserve funding or long-term care insurance also reduces risk.

6. Ashford may be financed in one of three ways (only two of which the developer is considering seriously). Resident financing (using upfront fees to take out the construction financing), provides a substantial startup profit at Ashford and allows the greatest risk-reduction by its ability to establish large reserves. Mortgage financing with a trust (investing the upfront fees in a trust whose income funds the permanent debt service), presents problems of negative arbitrage and reserve funding, among other drawbacks. Mortgage financing with an all-rental fee structure has disadvantages including affordability for residents and low profitability for the developer, although in particular inflationary circumstances it can be highly profitable. For reasons of risk reduction and profitability, this paper recommends resident financing for Ashford.

7. To build projects more affordable than upscale Ashford, developers should explore alternative product configurations in housing and service levels, and try new strategies to reduce the refund and nursing liabilities. Certain financing variations and new financial products such as inexpensive credit enhancement would also increase the affordability (or profitability for developers) of CCRC's.

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Introduction

Elderly housing is currently one of the hottest segments of real estate development---at least in terms of developer *interest*. Recreation-oriented developments for active retirees are commonplace, but actual market activity in developments serving the "old-old" is quite low. Such developments serving this portion of the elderly market are called "retirement centers." Retirement centers are attracting so much attention because of their potential to meet changing housing demand from American seniors. The American elderly population is expanding rapidly, both as a proportion of the entire population and in absolute numbers. An increasing proportion of the elderly themselves are the old-old over 75. A variety of ongoing economic and social factors have begun to circumscribe the housing arrangements these elderly have historically selected, and retirement center developers hope to be one of the main beneficiaries of this changing demand. Private-sector market activity, however, is in its infancy. Partly this reflects the fact that retirement centers are a new real estate product; partly it reflects their unusual complexity which makes development difficult.

Elderly Americans in general have three choices if they want housing designed specifically for them. Recreation-oriented developments for younger elderly are "go-go" developments. At the other end of the spectrum, nursing homes are the "no-go" choice for those who are dependent on nursing assistance. Retirement centers are the middle ground, the choice for "slow-go" seniors who are ambulatory and substantially capable of living independently yet in need of occasional assistance. These elderly are virtually all over 70 years old, and mostly over 75.

Retirement centers generally fall into two categories, the continuing care retirement community (CCRC) and the congregate community. This paper primarily focuses on continuing care facilities, but distinctions between the two types are blurring and reference will be made to congregates as necessary. Both CCRC's and congregates group housing units around common-area amenities, which include dining facilities, and they frequently

provides an extensive array of services for residents such as housekeeping, laundry, transportation, group activities and social counseling in addition to meals. The main defining difference between continuing and congregate (other differences are common in practice) is the provision of nursing care as a service. CCRC's usually have a nursing center on-site for resident use, and more importantly the project as a whole subsidizes the cost of nursing care when particular residents use it. "Lifecare" projects are those that subsidize usage so that a resident never pays more in the nursing center than in the housing units (except perhaps for meals) and that guarantee that a resident will always have access to nursing.

Congregates do not have nursing centers as part of the facility, and residents who need long-term nursing care must move. Congregate operators are blurring distinctions, however, by establishing liaisons with nursing homes off-site. The nursing home operator may give priority access to outplaced congregate residents, and may even subsidize patients from the congregate out of nursing home funds. In practice, several other characteristics differentiate CCRC's and congregates. Continuing care facilities usually require an upfront fee in addition to monthly fees, and attract a more affluent market. Congregates are almost always rental and, partly because some congregates are publicly-sponsored, their residents are generally less affluent. But these distinctions may not survive the rapid product experimentation now transpiring.

A more recent product type, currently termed "assisted living," is a step closer to traditional nursing homes. Built either within continuing care communities, within congregates, or as stand-alone projects, assisted living units provide most services in the resident's own unit, including meals, and help with bathing and dressing. The in-unit assistance does not include nursing care.

1. SOCIAL AND ECONOMIC TRENDS DRIVE DEMAND FOR RETIREMENT CENTERS

Few American seniors make any changes in their living arrangements after the age of 70. While some move in with children during these years, and some into nursing homes, retirement moves mostly occur much earlier when seniors are more active. Typically this move is made to a recreation-oriented retirement community.

A number of economic and social factors are now pressuring some seniors, willingly or not, to consider alternatives in their older retirement years. Social Security has in the last four decades vastly changed the economic status of seniors. Together with private pensions, it has made them more affluent on average than younger Americans, with a poverty rate of 12.4% versus 14.4% for the population as a whole.¹ But seniors face an expensive living expense that their marginally higher affluence does not help them afford: health care. They need more of it than the rest of the population, and its cost has long risen faster than inflation. The American health-care system makes *medical* care relatively affordable to most elderly, but not *long-term* care for which there is greater overall demand. Medicare has made physician and hospitalization expenses more affordable, but does not cover long-term nursing care (there is a 100-day limit on hospitalization). Medicaid does cover such nursing expenses, and in fact it is the source of over two-thirds of nursing home fees. But Medicaid is a means-tested public-entitlement program which excludes most elderly. Thus elderly who do not qualify for Medicaid, and cannot independently afford nursing homes or in-home nursing care, are severely limited in obtaining nursing care.

Continuing care seeks to provide nursing care at a more affordable overall price. Several other nursing-care factors also strengthen demand for CCRC's. One is the negative, institutional image of nursing homes in general, which causes seniors to resist relocation to one. Another is the need among many elderly for short-term nursing care only. Hospitalization and in-home care, used historically for this, are increasingly prohibitive.

¹T.E. Ricks, "People's Perception of the Elderly As Being Poor Is Starting to Fade," *Wall Street Journal*, 19 December 1985.

Finally, and perhaps most important, many seniors have no immediate need for nursing care but rather expectations of need. For them continuing care is insurance that it will be available and affordable.

Other factors, some cost-related and some not, have created demand for congregate as well as continuing care housing. The cost of in-home household assistance which many elderly eventually need, such as housekeeping and cooking, is increasingly unaffordable. Increasing mobility throughout society often results in a long-distance separation between parents and children. This reduces the availability of free assistance as well as children's immediate social support.

All the above are need-based factors providing demand for slow-go housing. At least two discretionary factors also generate demand. A desire for more companionship is inducing some to forsake living alone for more structured environments. Also, fears of personal security are influencing elderly to live in environments more secure than individual homes.

Retirement centers are not the only mechanism to address these demands. Much academic discussion in the last decade has suggested methods to allow elderly to use equity in their homes to generate income for nursing and other costs, while enabling them to remain at homes. Yet sale-leasebacks and reverse annuity mortgages have rarely been put into practice, in part because home equity is often too low to generate substantial income. CCRC's and congregates can provide the services and social support that older seniors need, at a lower cost which reflects centralized delivery and economies of scale.

2. THE PLAYERS IN A NEW INDUSTRY

Non-profit groups were the first to develop these new housing types. Non-profit ethnic and religious self-help organizations built antecedents of lifecare as early as the 1920's. In the 1960's congregate and lifecare projects became more common. Proprietary interests, alone or in joint-ventures with non-profits, began activity in slow-go housing in the 1970's. Interest has continued to grow although actual development by proprietary firms has

been relatively infrequent. The efforts of the non-profits will continue to be vitally important in serving the lower-income portion of the market, especially in this era of diminishing direct public subsidies for housing of all types. The impending entrance of more proprietary firms, however, offers considerable benefits to the public as well as profit opportunities for the companies themselves. The main public benefit may be far greater availability of slow-go housing to a broader spectrum of the elderly population. More facilities should be available to middle income seniors as well as the more affluent.

The entrants to the field include not only real estate developers but also hospitality and health care firms which view retirement centers as an opportunity to diversify into related fields. Hotel firms such as Marriott recognize the similarity of retirement center operations to hotels, and in some cases have extensive real estate development experience. Hospitals and nursing home groups such as Beverly Enterprises view retirement centers either as locations for outplacement (hospitals) or feeders of private-paying patients (nursing homes). Nursing homes are a component of continuing care facilities, and for specific sites nursing homes may simply build the residential units on adjacent land. All these players can benefit from joint ventures with each other and local non-profit organizations. Others, such as insurance companies, may emerge as financial players in the industry.

All these players, however, face a major restraint in addition to the currently limited market size: CCRC's, and to a lesser extent congregates, are extremely complex. CCRC's are four businesses in one: housing, services, nursing care, and insurance. Development and operation is far more intricate than other for-sale housing or apartment development. Real estate developers, for example, are generally unfamiliar with all but the housing component of CCRC's, and may even misunderstand the housing marketing process which is different from most real estate marketing. Hospitals are not used to providing long-term care in a residential setting. When the complexities of CCRC's are combined the pressures a new product faces in the financial and retail marketplace, the result is that financing them successfully is a major hurdle for the proprietary developer.

This paper explores the complexity of continuing care communities in detail, and concentrates on how it affects project financing and retail fee structures. Chapter 2 expands on the above discussion of demand with a demographic overview of the CCRC target market. Chapter 3 describes the problems created by product configuration, state regulation, high physical plant costs, difficult marketing, and operating issues such as slow maturation of the community and nursing expenses. Chapter 4 presents the alternative retail fee structures for a CCRC, and discusses various debt financing sources. Chapters 5 and 6 are a case study of a particular CCRC under development which portray how the aforementioned concerns have influenced the financing of one facility. Based on this empirical analysis, general financing recommendations are made. Finally, Chapter 7 comments on strategies which might benefit the financing of CCRC's.

This paper serves as an introduction to continuing care for the general reader. It shows that the risks associated with CCRC's far exceed the usual real estate risks of high vacancy, cost overruns, and interest rate fluctuations, but that it is possible to profit considerably while delivering a product of high social utility.

The Market for a New Product: A Demographic Overview

More than most types of housing, retirement centers serve highly specific needs of the elderly in both services and housing layout. It is essential to tune projects to these specific needs. This specificity also limits the size of the market. Continuing care and congregate communities appeal to the same market in some respects, but the higher cost and the nursing component of continuing care attract a market that is generally more affluent and more concerned about future health needs. Innovative product variations, however, are blurring the distinctions between these two products, continuing care and congregates. As a result, this is blurring their respective target markets as well. This chapter therefore discusses the basis of demand for both product types and points out the differences where relevant.

Local circumstances may cause variations in demand as well, and extensive local market analysis is necessary to determine the presence of an adequate market for a project. Examining the depth and competitiveness of a selected market area, especially in the context of a particular site, is a vital preparation to determining economic feasibility based on project financials. Nevertheless, a review of national demographic data will suggest in crude terms the overall size of the market, and indicate what opportunities and limitations exist for proprietary developers.

This discussion indicates the depth of the market by surveying population and household growth, living arrangements and household size, and the frequency of need for assistance. It also surveys spending ability of seniors from both current income and liquidated asset sources, and correlates this to affordability of housing projects. Finally, a brief examination of migration patterns and mobility rates shows some regional variation in the market as well as absorption constraints.

1. THE RESIDENT PROFILE

The typical resident of a congregate or CCRC is 80 years old, unmarried, and female. One survey of CCRC's found the average age of residents to be 80.2 years.¹ The average age of entry is slightly younger, at 78.0 years.² Data available for age of entry and resident age in congregates is similar despite the congregates' lesser emphasis of health care.³ Beyond these generalities, retirement centers can include seniors from 70 to over 100, married couples and unmarried men. These projects attract "second-stage" retirees, who are mostly over 75 years old, and virtually all over 70. (Somewhat superfluous age requirements usually set a minimum of 62 or 65 years.)

Size of the Market. The over-70 age group, the primary market for slow-go housing, is the fastest growing age groups in the United States. It is increasing in absolute size and as a proportion of the total population. TABLE 2-1 shows long-term trends.

Developers should note that the size of this group is not huge compared to the market for first-time-buyer housing or move-up housing. The population of seniors 75 or older, however, is projected to almost double between 1980 and 2000, when it should constitute 6.5% of the population, and then increase by two-thirds again before 2030, when 9.8% of the population is projected to be 75 or older. The growth will not be constant, reflecting baby booms and busts; the decades with the greatest percentage increases are 1990-2000 and 2020-2030. The higher average growth rates of the elderly population will lead to an increase in their proportion of the population as a whole. Among the elderly themselves, growth will be highest among the "old-old." There are currently far fewer over 75-year olds than 65-75 year olds, but the older group is growing faster and eventually will predominate. All these statistics

¹Howard E. Winklevoss and Alwyn V. Powell, *Continuing Care Retirement Communities: An Empirical, Financial and Legal Analysis*, Homewood, IL: R.D. Irwin, 1984, p. 48.

²Laventhol and Horwath, *Lifecare Retirement Center Industry 1985*. Philadelphia, PA: Laventhol and Horwath, 1985, p. 22.

³Real Estate Research Corporation, *Rental Retirement Housing: New Opportunities*, Washington, D.C., date unknown, p.12.

TABLE 2-1: ACTUAL AND PROJECTED ELDERLY POPULATION, 000's

YEAR	TOTAL	65-74	%	75-84	%	85+	%	ALL 65+	%
1970	203,310	12,447	6.1%	6,124	3.0%	1,409	0.7%	19,980	9.8%
1980	226,505	15,578	6.9%	7,727	3.4%	2,240	1.0%	25,545	11.3%
1990	249,731	18,054	7.2%	10,284	4.1%	3,461	1.4%	31,799	12.7%
2000	267,990	17,693	6.6%	12,207	4.6%	5,136	1.9%	35,036	13.1%
2010	283,141	20,279	7.2%	12,172	4.3%	6,818	2.4%	39,269	13.9%
2020	296,339	29,769	10.0%	14,280	4.8%	7,337	2.5%	51,386	17.3%
2030	304,330	34,416	11.3%	21,128	6.9%	8,801	2.9%	64,345	21.1%
AVERAGE ANNUAL COMPOUND GROWTH RATE, 1980-2020:									
	0.6%	1.6%		2.0%		2.8%		1.9%	

Source: Housing a Maturing Population (ULI)

suggest a vastly increasing market for slow-go housing, although only a fraction of the age-targeted group, as discussed below, will be able to afford proprietary projects.

Equally important for housing development is household growth. While declining numbers of 65-74 elderly from 1990-2000 (see TABLE 2-1) will mean little growth of 65-74 households during this decade, 75 and older households should increase continually through 2030. Declining average household size will also contribute to growth in the number of households, but this decline is stabilizing. It should not be as important a factor as absolute growth itself.

Living Arrangements. The tendency of congregate and CCRC residents to be female and single, widowed or divorced reflects both demographic conditions and housing preferences. Residents comprise on average 20%-25% males.⁴ This is one male per four or three females. This primarily reflects longer lifespans of women, who as a result dominate the 75-plus population. There are 1.78 women for every man among over 75 year-olds. Furthermore, men who are widowed as retirees tend to remarry, while women do not largely because there are not enough available men. 1980 Census data shows the disparity in marriage rates of the elderly (over 65):

TABLE 2-2: MARITAL STATUS OF THE ELDERLY (65+), 1980

	<u>Men</u>	<u>Women</u>
MARRIED	77.0%	51.0%
WIDOWED	14.0%	40.0%
SINGLE/DIVORCED	9.0%	9.0%
<i>TOTAL</i>	100.0%	100.0%

Source: Real Estate Research Corporation

Reflecting their marital status, under 15% of men live alone but nearly 40% of women do so. Because of preference elderly who live alone are more likely than their married cohorts to move out of individual housing, for reasons relating to companionship, security and need for personal and

⁴Laventhol and Horwath, p. 23.

household assistance. Frequently couples who do move to slow-go housing include one spouse with some sort of ailment.

Personal Assistance. The last factor, need for assistance in daily living, is one of the prime causes of demand for slow-go housing as elderly seek such assistance at lower cost than available in individual homes. The percentage of elderly needing such assistance is as follows:

TABLE 2-3: PERCENTAGE OF POPULATION NEEDING ASSISTANCE IN DAILY LIVING

	<u>Percent</u>
18-44 YEARS	1%
45-64 YEARS	3%
65-74 YEARS OLD	7%
75-84 YEARS OLD	16%
85+ YEARS OLD	39%

Source: US National Center of Health Statistics

These figures include those who need skilled nursing care (registered-nurse level) or intermediate nursing care (practical-nurse level) as well as those who need only non-nursing custodial care. About 25% of elderly eventually need nursing care, but at any one time in the U.S. today only about 5% of the over-65 population is in a nursing home. Not all elderly wait until a need for assistance develops to move from individual homes to retirement centers, but a large proportion does. Most residents have at least one chronic ailment upon entry.

2. THE AFFORDABILITY FACTOR

Many factors limit the market size of slow-go housing to less than the age-qualified group, including low mobility rates and a preference for individual housing as discussed below. But the major constraining factor, as with other housing development, is affordability. The elderly poverty rate is slightly lower than the rest of the population's, but it is still significant. While congregate and continuing care housing may represent opportunities to economize for middle- and upper-income individuals by reducing the costs of services and nursing care, proprietary projects are still beyond the reach

of a large segment of the age-qualified population. Unsubsidized non-profit projects may only be marginally less expensive.

Slow-go housing should be slightly more affordable than other housing because, with many services usually included, residents can spend more of their income on fees. Furthermore, the use of tax-exempt financing in some congregate projects requires inclusion of below-market units. Yet the problem of affordability remains significant. The following review of seniors' economic status will illustrate how it will limit market penetration of slow-go housing.

Qualifying Income. Because services such as one or more meals a day, linen, housekeeping, and transportation, and limited amounts of nursing care in CCRC's, are usually included in fees, seniors without other debts can spend up to 60% of their gross income on rent and maintenance fees. In practice, most spend 40%-50%.⁵ With \$15,000 of income, a household can afford a monthly fee of \$750 if spending 60% of its income. Currently, monthly fees in the least expensive proprietary congregate projects start at about \$750-\$800 per month. Thus cash income of \$15,000 is the ostensibly the approximate threshold of affordability.

However, this slightly understates affordability for several reasons:

- 1) Shared living arrangements, such as roommate-style two bedroom apartments, allow residents to substantially reduce individual fees by living with friends or non-spouse relatives.
- 2) Third parties, such as children or insurance companies, may contribute to the cost of the housing. Third parties have historically paid only about 1% of nursing home costs directly, and there is no indication that childrens' contributions would significantly increase for slow-go housing.⁶ However, insurance policies covering long-term care may become more common.

⁵Al Scott et al, conference on lifecare, NAHB annual convention, Dallas, January 1986 (from tape).

⁶Winklevoss, p. 6.

3) Most importantly, seniors moving into slow-go housing are likely to convert home equity into income-producing assets, if it is not needed for entrance fees or unit purchase.

Home Equity. Over 70% of over-65 households are homeowners, with little difference between 65-74 households and over-75 households.⁷ (There is a drop from the 55-64 age group as initial retirement changes are made.) Over 80% of the elderly own their homes free and clear. Average net home equity per household is \$69,700 in the 65-69 group, \$57,800 for 70-74 year old homes, and \$55,100 for 75 plus homes. Median equity for all groups is considerably lower.⁸ When potential income from converted equity is added, affordability increases significantly. While the equity is frequently not enough to pay for entrance fees at proprietary projects, which often start above \$100,000, it enhances the affordability of rental projects.

TABLE 2-4 shows income distribution of households 70-plus. Cash income includes social security, investment income, government and private pensions, and earnings from elderly who continue to work.

TABLE 2-4: INCOME DISTRIBUTION OF 70+ HOUSEHOLDS, 1985

Income	CASH INCOME		WITH POTENTIAL EQUITY*	
	Households	%	Households	%
\$0 - \$9,999	2,337,000	19.0%	1,845,000	15.0%
\$15,000-\$24,999	2,337,000	19.0%	3,198,000	26.0%
\$25,000-\$34,999	984,000	8.0%	1,107,000	9.0%
\$35,000 +	1,107,000	9.0%	1,722,000	14.0%
TOTAL	12,300,000	100.0%	12,300,000	100.0%

*Assuming homes are sold and net proceeds invested at 10%.

Source: Real Estate Research Corporation

The proportion of households meeting the cut-off threshold for proprietary, all-rental congregate housing may increase by more than a third with home equity. The table above indicates that a maximum of 36% of households

⁷Real Estate Research Corporation, p. 8.

⁸*ibid.*

TABLE 2-5: AFFORDABILITY OF MONTHLY PAYMENTS WITH EQUITY INCOME, 1985

	HOUSEHOLDS THAT CAN AFFORD INCLUSIVE MONTHLY PAYMENTS OF:					
	\$800	\$1,000	\$1,200	\$1,500	\$1,800	\$2,200
ONE PERSON HOUSEHOLDS						
70-74	905,000	518,000	391,000	197,000	128,000	107,000
75+	1,446,000	885,000	556,000	390,000	340,000	320,000
Percent of total	40.1%	32.4%	31.2%	32.5%	30.9%	36.6%
TWO PERSON HOUSEHOLDS						
70-74	1,569,000	1,249,000	914,000	484,000	320,000	171,000
75+	1,943,000	1,678,000	1,177,000	737,000	725,000	570,000
Percent of total	59.9%	67.6%	68.8%	67.5%	69.1%	63.4%
TOTAL	5,863,000	4,330,000	3,038,000	1,808,000	1,513,000	1,168,000
PERCENT OF ALL HOUSEHOLDS	47.7%	35.2%	24.7%	14.7%	12.3%	9.5%

Source: Real Estate Research Corporation

could afford slow-go housing, or 49% with income from home equity, although the actual percentages are somewhat different, reflecting household size (fees for two-person units are higher) and income (lower incomes can spend less than 60% of their income). Taking these factors into account, TABLE 2-5 presents a more precise profile of affordability. (The figures assume that monthly fees include one meal per day, utilities, linen, transportation, and housekeeping. Income spent on housing ranges from 50%-60% depending on household type.)

TABLE 2-5 also shows decreasing affordability for higher cost developments, which significantly narrows the market for CCRC's in comparison with congregates. Proprietary CCRC's, to be financially solvent as all rental programs, would be at the top of this range. No proprietary, full-service CCRC's could charge as little as \$800 per month on an all-rental basis. They could charge \$800 per month combined with entrance fees, which typically range upward of \$100,000 at proprietary projects. Based on affordability alone, a much larger market exists for congregates. The affordability factor is the strongest challenge facing developers of continuing care facilities today. Developers of proprietary CCRC's must bear in mind that their customers, while growing fast, are few in number to start with.

In the future, the affordability of both congregates and CCRC's should be helped by rising elderly income from private pension funds, whose coverage of the population and benefits in real terms are rising. In fact, elderly income as a whole is projected to grow in real terms.⁹ And social security, although it accounts for a minority of seniors' income, helps make incomes inflation-proof as benefit increases keep pace with the Consumer Price Index. The long-term future of Social Security is questionable, but in the near future it should provide stability in benefit levels.

⁹*ibid.*, p. 11.

3. NOT-SO-MOBILE: PROBLEMS IN ACHIEVING A HIGH CAPTURE RATE

Affordability is one problem retirement center developers must face. The reluctance of "old" seniors to move out of their individual homes and change lifestyles is another one. Biases against moving will keep the majority of qualified seniors away from slow-go housing. If seniors move at all in their retirement, it is likely to be in their "first-stage," active retirement years. Many construe a move to slow-go housing as an admission of frailty, and thus resist it. Although exceptions exist, usually the move comes *after* the onset of some health ailment and the benefits of a move are recognized.¹⁰ This behavior may change as the concept becomes more familiar. For now, the result for developers is slow absorption. Projects of 150 units or more are likely to take 18-36 months to lease up or sell out.

Low elderly mobility rates reflect this bias against change in living arrangements. While 7% of owner occupants in the U.S. moved from 1982-1983, only 2% of over-65 households did. For renters, the respective percentages are 32% and 9%.¹¹ Since those likely to be able to afford slow-go housing, especially CCRC's, are also likely to be owners with equity income, the effective capture rates are much lower than the affordability rates. Currently, estimates of market capture range from 2% to 5% of the age-qualified, income-qualified seniors in a market area (including home equity).¹² When separate projects are competing in the same market areas, their individual capture rates are necessarily lower than the overall capture rates. Over time, overall capture rates will increase as slow-go housing becomes easier to market. In the meantime, affordability and mobility constraints are a reality. Some markets may be overbuilt as premature development outpaces absorption. Detailed local market studies and competitive analyses are vital to verify an adequate market.

¹⁰Interview with Sandra Howel, M.I.T., Cambridge, Mass, May 1986.

¹¹Stockman, Leslie and June Fletcher, "A Maturing Market," *Builder*, June 1985, p. 75; and Real Estate Research Corporation, p. 7.

¹²*ibid.*, p. 15; and Richard Jaffrey, conference on retirement centers, NAHB annual convention, Dallas, January 1986 (from tape).

Current concentrations of elderly, and their migration patterns, show some regional variation. Growth rates among the elderly population are highest in the Sunbelt and in the West. California, Arizona and Florida have particularly high elderly growth rates since they serve as "magnet" states for interstate movers. Interstate mobility, however, is not important for retirement centers. Most of the interstate movers (who only constitute about 10% of all elderly) are too young for retirement center housing and are couples who are less likely than singles to move out of individual housing. Slow-go housing attracts residents from highly localized market areas; most purchasers come from within their state, and those who do not are usually returning to their pre-retirement areas after an earlier retirement move. Thus feasible market areas, depending on competition, often exist everywhere a 10-mile market has enough income and age qualified elderly to sustain a project at the expected capture and market share rates. Such market areas are just as frequently *outside* the South and West as inside. In 1980 over half of Americans over 65 lived in just seven states: California and New York each had over two million, while Florida, Illinois, Ohio, Pennsylvania and Texas each had over 1 million. Because of its unique nature, slow-go housing does not compete with other types of housing stock. Rustbelt markets with little opportunity for other types of housing development can support slow-go projects.

The eventual potential of retirement centers is difficult to estimate, due to the unpredictability of capture rates. Currently 1.0%-1.5% of 70-plus households live in slow-go housing. There are at least 140,000 units in congregate and CCRC's, not including adjoining nursing beds.¹³ Very few of these projects are proprietary. Thus the total stock of retirement center units is a fraction of the annual production of multifamily homes. The market is almost certain to expand considerably as economic and social pressures strengthen demand, and as the concept becomes more familiar and projects more attractive. Expectations of market acceptance seem justified by data such as a preference survey in which 2.3%-6.5% of retirees would

¹³Stroud Curran, conference on lifecare, NAHB annual convention, Dallas, January 1986 (from tape).

certainly live in continuing care or congregate care respectively, and 54.6%-58.7% would consider them.¹⁴

The demographics suggest a downside risk as well. As noted above, it is a growth market but a small one at present. In the real estate environment of the 1980's developers are generally expanding into new products faster than they have in the past. In the retirement center field, real estate firms also must compete with outsiders as well. But for one factor, the attention slow-go housing receives at conferences and in trade publications suggests that overbuilding would emerge in some areas. That factor is the number of obstacles that make development difficult even when an adequate market exists. Chapter 3 points out some of these obstacles in more detail.

¹⁴Eli Adams, "The Graying of America," *Professional Builder*, April 1986, p. 69.

The Obstacles to Continuing Care Development

In the realm of commercial and residential real estate, developing a continuing care community is an extremely complex endeavor. It rivals large, mixed-use urban development for complexity. This chapter discusses some of the aspects of CCRC's, aside from financing issues, that complicate their development. These characteristics require special development and management skills, mandate prolonged development planning and start up periods, and require adherence to high levels of regulation. It is also important to understand how some of the financing complications are responses to these management, timing and regulatory factors. Structuring better financing mechanisms necessitates in part accommodating these influences.

These development difficulties frequently result in higher initial and operating costs, although it is not clear that corresponding higher financial returns compensate. The realizable returns are also frequently different in nature than those from other real estate investments. They help to explain why proprietary real estate developers have not been more active in continuing care housing, and why proprietary developers from outside the real estate field, such as health care and hotel firms, are among those who have made initial forays into the field.

1. FOUR BUSINESSES IN ONE: THE COMPLEXITY OF THE PRODUCT

Continuing care projects include an array of housing, service, health care and even insurance provisions that make for a complex real estate product. CCRC's may have unit types and services to cater to virtually anyone over 70 years old short of those who need acute care. Alternatively, they may be a more narrow product. The first development obstacle is to define precisely the program for a given development.

Project Size and Mix. Two surveys of continuing care projects indicate what typical configurations are, how they vary between proprietary and non-profit developments and what trends are appearing in new centers.¹ Another survey of congregates indicates how CCRC's differ.² The two surveys of continuing care communities describe almost entirely non-profit projects, and they also include a large number of early facilities built before 1970. Perhaps fewer than 10% of CCRC's in operation now are proprietary, although proprietary firms are frequently involved in non-profit projects as managers and development consultants. One of the surveys found a median of 165 units, with 217 for post-1970 projects. The survey of congregate projects, all of which were market rate rental projects, showed an average project size of about 150 units.

Both congregate and continuing care projects have predominately one bedroom units, with a few studios and slightly more two bedroom units. Recent proprietary projects appear to have increased the number of two bedroom units at the expense of studio and one-bedroom units, hoping to attract more couples and to entice prospects who live in relatively large homes. Another trend is that while developers are eliminating studios as individual units, they are increasing them as personal or assisted care units. These are units in which assistants (not nurses) serve meals, help residents dress, do housekeeping, etc. Congregate developers as well are increasingly building assisted care units to retain residents who would otherwise move out when they could not support themselves independently. This is one way by which congregates are blurring distinctions with CCRC's. About half of CCRC's have personal care units, and nearly all have separate nursing beds in a centralized nursing center. Usually the nursing center includes both intermediate and skilled nursing beds in a mixture of semi-private and private rooms. CCRC's generally have between three and five independent living units per nursing bed.

A summary of typical project configurations is as follows:

¹Laventhol and Horwath, and Winklevoss. Each surveyed 100-200 projects, almost all of which are non-profits.

²Real Estate Research Corporation. Surveyed over 40 proprietary projects.

TABLE 3-1: TYPICAL CCRC UNIT MIX AND FACILITY SIZE

	<u>Unit Mix</u>	<u>Size</u>
ILU'S*		
STUDIOS	0%-20%	350-450 SF
1 BR	50%-60%	550-750 SF
2 BR	20%-50%	650-1000 SF
TOTAL ILU'S	200-300	
ASSISTED UNITS	20-50	330-450 SF
NURSING BEDS	60-120	330-400 SF
ACTIVITY CENTER		18,000-30,000 SF
TOTAL FACILITY SIZE		230,000-400,000 SF

* Independent Living Units

Source: Real Estate Finance Journal, Summer 1985

Deciding on the overall project size, and the unit mix and unit size, is a critical development decision. Because of the labor-intensive services and common area amenities in most projects, economies of scale play a big role in profitability. At the same time, management control considerations and the need for a residential atmosphere limit project size.

Service Provisions. According to the surveys, levels of service provided are even more varied than unit types, and their pricing, as discussed below, depends on whether the services are offered inclusively or "unbundled." Access to nursing care is guaranteed by virtually all CCRC's under some sort of pricing. Availability of other types of basic health care vary. 25%-35% provide for routine exams and a third have a physician on staff. Virtually all require entering residents to have full medical insurance, such as Part B of Medicare, to pay for further medical care in hospitals. Such insurance provides very limited reimbursement of nursing home care.

All CCRC's (and congregates) provide common dining service, from one to three meals a day, and a majority provide tray service in units and accommodation for special diets when needed. Services usually include social counseling, recreational therapy and limited transportation, as well as provision of flat linen and weekly or biweekly apartment cleaning. Most CCRC's arrange social and cultural activities and outings for residents.

This complexity in physical and service characteristics creates many opportunities in financial structuring. Nursing and meal services, for example, can be treated as separate profit centers or as expenses. Recent CCRC facilities have experimented with the "unbundling" of services, pricing them on a fee-for-service basis, to make projects more affordable to those who don't want or need the services. Likewise, all income can be commingled or can be earmarked for different expenses such as debt service or nursing. There are numerous choices in determining a program, and usually each has different financial implications.

2. THE PRESENCE OF STATE REGULATION

While all real estate development is subject to local regulation in the form of zoning restrictions, building codes, and sales procedures, continuing care is increasingly subject to greater levels of regulation. States generate most of this regulation. It can affect project financing and operating procedures as well as the zoning and sales stipulations that normally bear on development. Nursing centers are regulated separately as well in all 50 states. While nursing home operators entering the field are experienced in doing business with this degree of state regulation, other proprietary developers generally are not. This factor has probably deterred some from entering the field, and the state-mandated procedures must be addressed in the development process. •

Nursing Center Regulation. State nursing home regulation generally centers on the requirement for a Certificate of Need (CON). One reason states control construction of nursing beds is to control Medicaid costs; since a majority of reimbursements are paid by Medicaid, regulations are felt to prevent pass-through of excessive costs when facilities are built unnecessarily. The nursing centers of CCRC's may be "closed," meaning only available to CCRC residents, in which case only design guidelines and not the CON requirement may apply. But far more likely are "open" nursing centers which allow utilization of empty beds by non-residents, and generally require adherence to local "bed need" limitations before a CON is granted. Obtaining CON's for nursing centers may also be complicated by the negotiation of resident and non-resident allocation of beds. By guaranteeing

nursing beds to residents, it may be necessary to keep beds empty even when outsiders want them.

Two states (California and Illinois) may soon take steps toward exempting CCRC nursing centers from the CON procedure entirely. Massachusetts, at least, allows special approval for CCRC nursing centers that stand-alone nursing homes do not benefit from. These regulations reflect a rationale that CCRC nursing centers serve mostly the community itself after maturation, and that they should be encouraged because they provide low-cost nursing care to some elderly who might otherwise deplete their own funds to qualify for Medicaid. If less regulation of CCRC nursing centers becomes a trend, then the time-consuming CON process may no longer be a part of developing most CCRC's.

CCRC Regulation. Aside from the regulation of the nursing component, 13 states, at last count, regulate CCRC's themselves. The states are Arizona, California, Colorado, Florida, Illinois, Indiana, Maryland, Michigan, Minnesota, Missouri, New York, Pennsylvania, and Wisconsin. More states, including Massachusetts, are now considering regulation. These regulations originated with a number of project failures, both non-profits and proprietary, in the late 1970's and early 1980's. Most of the failures were due to unintended undercapitalization, but some may have involved fraud. They brought attention to the possibility that seniors might lose their life savings. The regulations vary from state to state, with provisions that vary in extent of their coverage. One state, New York, prohibits CCRC's outright. All-rental facilities are generally exempt. At their most extensive, the regulations have three general provisions:

- Predevelopment certification to screen developers and sponsors
- Disclosure provisions to residents before and after purchase
- Financial stipulations to prevent the loss of buyers' funds

Predevelopment Certification. At least nine states with the most comprehensive regulations require project certification. The certification rules attempt to determine the "financial stability and capacity, the sincerity,

and the integrity" of continuing care developers.³ Most do so by requiring submission of financial condition and projected financial data from projects such as income statements and balance sheets. Annual resubmittal of the project data is required, and some states recertify the facilities while in the others the original certification is valid until revoked. Certification is necessary before sales contracts can be signed. The information disclosed to states is information that competent developers will assemble for their own proformas. The main effect on developers may be increased development time.

Disclosure. The disclosure requirements are similar to condominium offering statements except that more financial projections are required which include basic cost and sales revenue data rather than simply income and expense data. At least two states also require annual disclosure of this information to current residents. While the basic level of information disclosed does not fully expose financial structuring of a project, it should have the effect of encouraging financial solvency. Conceivably, it may discourage some innovative financing techniques.

Other provisions relating to purchaser rights include stipulations on sales procedures such as "cooling off periods," and the right of residents to form residents' associations. All of these purchaser rights provisions are like condominium regulations. Some states, however, are giving purchasers greater ability to rescind contracts than with other real estate, making it possible for a presale buyer to change his or her mind at any time for a full refund of the deposit. This makes purchase and sale agreements somewhat useless as collateral for construction loans.

Financial Status. The financial provisions relate primarily to the escrowing of buyer's funds before they occupy their unit and the establishment of a reserve fund. In a sense, escrow requirements are a backup protection for residents in case the certification and disclosure regulations do not effectively prevent project failure in the initial

³Winklevoss, p. 231.

development stages.⁴ During presale efforts especially, the failure of an anticipated market to materialize will not endanger initial buyers' payments if escrow procedures are in place. The escrow regulations restrict access to funds that could otherwise be available for construction. Furthermore, release of the funds may not come at occupancy; in some states if fewer than 50% of units are finished and occupied then release is delayed.

Some states require a proportion of presales before construction can begin to reduce risk. Requirements for reserve---money which must be set aside for contingencies---range from a full year's debt service to no requirement. These attempt to ensure short-term solvency if actuarial predictions are wrong, expenses unexpectedly high, occupancy drops or income generated from turnover is too low. Many of the states also mandate refunds of entrance fees at a given amortization rates.

Because of the regulations' definitions of the CCRC facilities which they cover, all the statutes affect projects with entrance fees and not rental, fee-for-service price structures. Thus developers can escape regulation through alternative fee structures, but in practice all-rental pricing is difficult to use because monthly fees have to be very high. Regulation of rental CCRC's has been proposed in several states. Regulation of congregates is also a proposal in some statehouses.

There is a bias against proprietary operators in some statutes, ostensibly based on feelings that profit-making activity involved caring for the elderly is prone to abuses. Michigan, for example, prohibits proprietary developers from "pure" lifecare development. This sort of bias, distinguishing non-profit from proprietary operators, does not seem to be a trend. At any rate, prohibitions on proprietary sponsorship could be easily circumvented by setting up non-profit development entities and earning revenue from management and development contracts.

Developers may debate whether the regulations are appropriate or not, but it is likely that most states will eventually have comprehensive laws. In the short

⁴*ibid.*, p. 233.

term, comprehensive regulations probably help the industry's public image, and in fact few of the stipulations are directly onerous. Their primary impact is to delay development time considerably, and to raise legal fees.

3. EXTRAORDINARY DEVELOPMENT COSTS

Some aspects of continuing care (and congregate) housing development constitute "extraordinary" costs that other housing development does not entail. This section describes them under the headings Physical Plant Costs and Marketing and Startup Difficulties.

Physical Plant Costs. CCRC and congregate projects have more comprehensive facilities than other types of residential development. Common areas include kitchen and dining facilities, lounges, and frequently convenience stores, workshops, meeting rooms, etc. Usually 10% or more of total floor area is devoted to such common area, around 20% to circulation, and the remainder of 70% to rentable space. This efficiency ratio of 70% is lower than in apartments, whose ratio is usually above 80%. Amortizing the cost of these facilities over more units obviously decreases the per unit cost. Nursing centers in CCRC's occupy additional area. They further increase cost per unit, although states often set a maximum cost regardless of who pays.

Retirement center projects do not need some outdoor amenities which other multifamily housing normally includes. Pools and tennis courts, for example, are not standard in most market areas. High parking ratios are also unnecessary. Ratios of 0.5, or even 0.25 spaces per unit are usually adequate, although it is sometimes difficult to get local approval for such a low ratio. Unlike some amenities in other types of projects, in slow-go projects the common facilities must be built upfront rather than phased with construction of units. Some, such as dining facilities, are necessary for operations. And residents do not have the disposition to wait for long-term delivery of amenities.

Living units and common areas require some special design and equipment for elderly needs. These increase construction costs over typical multifamily

construction, but also require extra time and expertise in the design phase. The units usually include emergency and safety equipment such as call systems in bedrooms and bathrooms tied to central stations, and grab bars in baths. Some units may be fully equipped for handicapped use. They should also include convenience features such as lever doorknobs and high placement of outlets. In common areas convenience features such as handrails, color coding of materials and frequent placement elevators are desirable. (All independent units include full kitchens for marketing and regulatory reasons in the case of some Federal insurance programs.)

Frequently location is a greater factor in physical plant costs than construction. With highly localized primary market areas, it is necessary to locate projects in areas well populated with income-qualified elderly, near medical facilities, and near shopping. This usually indicates an urban or suburban infill location, not a site on the fringe of suburban development. As a result site acquisition costs can be higher than for typical new housing construction. Rezoning or special permitting is also common because few zoning codes provide for the retirement center mix of institutional and multifamily residential, especially if surrounded by an established single family area. Zoning approval is frequently a time-consuming part of retirement center development. And while zoning delays are common to most large-scale real estate development, with CCRC's regulation often exacerbates the delay by tying state CON approval to zoning approval. Thus it is not uncommon to have a development planning period of several years, time that is consumed by state approvals, zoning approval, design development, and presale marketing. The next section discusses the marketing factor.

Marketing and Startup Difficulties. Retirement center housing is hard to market, and the resulting long startup period is long and expensive. This has several ramifications in the financial structuring of projects. Part of the marketing difficulty stems from the newness of the product and resistance to it; part stems from the slow pace at which prospective buyers make decisions.

Congregate and continuing care projects exist in most metropolitan areas in the U.S., but their status as non-profit, stand-alone centers which may

advertise relatively seldom often keeps their profile low. Thus the concept of congregate and continuing care may be new to prospects. Even when it is not, the fee structures may be complex and require lengthy explanation to prospects, their lawyers and their accountants. The cost is high compared to housing options with less service, so the value of the services must be clarified. Rental fee structures are easiest to understand, and offer the most liquidity for residents. Entrance fees are little understood and difficult to market, especially when withdrawal or death does not qualify for a refund. Because marketing entrance fee schemes without refund provisions has become extremely difficult, most projects now give refunds on most of the entrance fee or on an amortizing schedule. Another alternative is to sell units as condominiums or coops, which is more marketable since it involves a form of ownership most prospects are familiar with. An objective in determining pricing, aside from financial factors, is to achieve high marketability.

Usually, commencement of construction is contingent on preselling or preleasing 50% or more of the project, because lenders, states or developers themselves set this target to minimize risk. The presales provide tangible evidence of project feasibility. From a marketing standpoint presales are hard to do because the project must be sold as a concept through representations.

Even with a familiar and marketable product, the purchasing habits of prospective residents results in a long startup period. Chapter 2 noted the low capture rates of retirement center housing. Most prospects prefer their own individual homes, and make decisions on a move with reluctance when they feel they must. Most wait until the onset of an ailment to move. A decision to move characteristically comes three to six months after the initial visit, following several subsequent visits, and involves children and lawyers or accountants. As with move-up housing, closing can be delayed by prolonged sales of former homes. Health screening of prospects, to ensure their ability at first to live independently, and financial screening may further eliminate some prospects.

A marketing obstacle proprietary developers must overcome is distrust. Publicity about failures and the predominance of non-profits in the field make some prospects wary of abuse and profiteering by developers. This perception problem should ease as adequately-financed and well-managed proprietary projects become more common. Different marketing techniques, such as cultivation of referral networks among community organizations, require special expertise in marketing congregate and CCRC projects. Combined with traditional, advertising-based methods the result is very high marketing costs, often \$4,000-\$5,000 per unit even for rentals.

The marketing difficulties have a substantial effect on the length of project startup. In most areas it takes 18 to 36 months to fully sell or rent all units. Since expenses outpace revenues during this period, a large deficit results and must be funded. Startup deficits are a more significant part of retirement center development costs than in other housing development. The start up losses greatly increase equity requirements under some financing alternatives. This is the final development cost that must be funded before normal operation begins, and a new set of "extraordinary" costs ensues.

4. EXTRAORDINARY OPERATING COSTS

After development and startup, the operation of continuing care housing introduces more considerations which distinguish the product from other real estate development. This section describes some of the financial and management implications that result from high service levels, the maturation process of the community, and the nursing subsidy. This section also reviews the basis for actuarial pricing.

Service Levels. The high levels of service in CCRC's require managing more personnel than most real estate developers are used to, and managing with considerable sensitivity to social concerns of residents. It is not unlike hotel management. A 200 unit, full service congregate might employ 50-60 people full time. A two hundred unit CCRC might employ over 100 people.⁵ For developers who do not have the expertise, outside managers can be hired.

⁵Laventhol and Horwath, based on median of 2.6 residents per employee.

Good management is essential to retain residents through such attractions as delicious food. Management practice can also play a role in such expenses as resident transfers to nursing or assisted living units.

But even good management can not resolve a number of inherent operating risks. The costs of the services are passed on to residents, but the number of services increases the number of variables leading to operating cost increases. Nursing care itself has increased faster than inflation for the past twenty years. Non-profit CCRC's have sometimes run into financial difficulty because they did not raise fees fast enough. Over time there must be flexibility in the ability to increase fees. Large fee increases raise the possibility of outpacing residents' incomes and forcing some residents to move out or be subsidized. Since evicting seniors is undesirable, financial subsidy should be an option. Financing should allow for a financial aid reserve, or a mechanism for putting liens against entrance fee refunds.

Community Maturation. Local market risks can affect revenues as with any real estate development, although competition is likely to be a greater threat than local economic downturns, since entering residents usually do not work. However, one characteristic affects the operating stability of CCRC's that is somewhat unique. This is the long period of maturation of a community before resident turnover and nursing utilization stabilize, and the risk that they will never stabilize. When communities open their doors, the initial group of residents tends to be in the same age cohort of 75-80. Yet life expectancy after entering a CCRC is 12-14 years.⁶ (It is about 10 years if living independently. Whether the differential is due to resident characteristics or CCRC environments has not been studied.) Thus there *should* be little mortality, and little turnover, for some time. One assumption often used is that attrition will increase one percent a year until it stabilizes at eight percent of all units in the eighth year, assuming full occupancy. However, variability in mortality and morbidity can cause fluctuating attrition rates.

⁶Winklevoss, p. 93-95.

The effect of the increasing turnover can vary depending on the project. If a project achieves full occupancy after startup and can cultivate a waiting list, it can resell or rent vacated units with little difficulty. If not, then the vacancy rate will increase and marketing will become a greater expense. Turnover maturation will effect cash flow where entrance fees from new residents are a significant part of income, this income will be scarce in the early years of a community if turnover rises slowly.

Nursing Subsidies. The slow maturation of the resident population also effects nursing center operations. The nursing centers of CCRC's (and to a lesser extent the assisted care units of congregates and CCRC's) are subject to slowly increasing utilization rates. They are also subject to high *variability* in utilization. This unstability can have several consequences. First, since most CCRC's guarantee that nursing beds will be available for residents whenever they need them, it is necessary to build for the maximum anticipated need, usually one nursing bed per four or five independent living units. Since full utilization occurs, if at all, only after the long maturation period, the CCRC operator must fill the nursing center with non-resident patients during this time. This introduces additional management and revenue issues. Second, and most important, high utilization rates raise costs for the community to the extent that the nursing or assisted care is being subsidized. When utilization is unstable, so are project expenses.

Actuarial Pricing. The subsidies of residents who need nursing or assisted care take the form of debiting entrance and monthly fees for nursing care at less than cost. As subsidies from within the project, the project is in effect a form of self-insurance. The problem for CCRC's is that it is hard to price them the way insurance should be priced---actuarially. Most insurance is priced based on actuarial predictions of beneficiaries' needs, and it covers enough beneficiaries to render the pricing reasonably adequate. A CCRC usually has fewer than 400 residents; this is so small a sample that its needs could greatly differ from the actuarial predictions. The pricing for the nursing care component should be based on actuarial predictions for the particular residents covered by the program.⁷ The price should be equal to

⁷*ibid.*, pp. 75-203 discuss actuarial argument.

the facility's actuarial liability, which is the present value of the future expenses for residents. Actuarial miscalculations, or lack of calculations, have led to the failures of several low-cost facilities which were undercapitalized. Such actuarial pricing could be either "open-group," whereby fees are set to cover all resident nursing care expenses for a set period, or "closed-group," whereby fees are set to cover a particular cohort of residents for their lives. Both methods would involve charging high fees initially in order to build up a reserve to pay for later health care utilization.

In practice, however, such pricing is not widely used, and it is unlikely that proprietary developers will undertake it themselves. Pricing for nursing care as well as the housing units is based instead on the traditional "real estate" method, determined by variables such as construction costs, the fair market price, and the amount of competition. Developers make assumptions about future utilization rates, and accept the operating risk that these assumptions may understate utilization. Setting standard fees on a hybrid basis (real estate for the housing and actuarial for the nursing care) seems appropriate. But actuarial pricing, however much it is justified, is likely to be too complex for individual developers to use for various cohorts of incoming residents. Developers increasingly hire actuarial consultants who advise on what future costs will be. As noted however, CCRC's are so small that using non-resident-specific actuarial data leaves much room for variation and increased cost. It is financially risky.

Alternative Risk Reduction. To limit operating risks without actuarial pricing, most projects establish large reserve funds to cover contingencies. Another way to limit the risk, which has become a trend in the industry, is to sharply limit the amount of nursing care that is included in standard fees. The original method of including unlimited care has frequently given way to limiting free nursing care to a set number of days and thereafter charging on a per-diem basis. Some projects go even farther, and price all nursing care on a fee-for-service basis. However, a hybrid pricing structure is likely to develop as insurance companies provide long-term care coverage for retirement housing residents which developers might purchase for residents at group rates. Such insurance is offered by a few companies now, but most current policies have limited usefulness because of low reimbursement rates

and other restrictions. However, insurance companies, by assuming the actuarial risks, may eventually relieve developers of this particular operating obstacle.

This chapter has outlined the product complexity, regulatory, development cost, and operating cost characteristics that make continuing care unusual and difficult. These obstacles are not insurmountable. They do constitute a battery of issues that financing must take account of. Chapter 4 reviews how CCRC's in general accommodate some of these issues.

Choices in Pricing and Project Financing

The panoply of financing alternatives for CCRC's involves two types of issues: retail pricing and project debt and equity financing. Making a choice is complicated because it must be informed not only by financial returns delivered, but by the regulatory and cost issues described in Chapter 3. This chapter presents financing issues in more detail. Part A outlines various options regarding fee structuring. Then Part B discusses the most common methods of project debt financing.

PART A: Fee Structure Alternatives

The choice of project financing generally must follow the decision of what the fee structure will be. That structure, whether it is an entrance plus monthly fee, a condo/coop purchase plus monthly fee, or entirely a monthly rental, will determine how much debt and equity financing is needed. The different structures have varying economic implications for the buyers themselves, and varying levels of marketability, which will affect the successful startup of a project.

While the "first wave" of continuing care projects guaranteed unlimited nursing care, the "second wave" has responded to actuarial risk by limiting care. The "third wave" is completely fee-for-service. Much current development attention is focussed on the third-wave type of product and on congregates which, if they offer any long-term care options, do so through affiliations with off-site providers. Yet the CCRC with unlimited care is a unique product with considerable underlying demand. Where it is possible to finance projects to allow this structure, at the very least the developer should accrue the advantages of a marketing edge.

1. ENTRANCE AND MONTHLY FEE STRUCTURE

Historically most CCRC's have used a combination of entrance and monthly fees. The entrance fee buys entitlement to services and shelter but is not like a fee simple real estate purchase. This is a difficult ownership vehicle to market since most prospects are unfamiliar with it; in fact it may be unique to retirement center housing. Early lifecare projects gave no refund on entrance fees when residents died or left the facility, and often promised unlimited nursing care. The failure or default of a number of undercapitalized early projects has made many consumers wary of projects with entrance fees. Aside from finding it difficult to pay for unlimited nursing care, early sponsors found that prospects and their children did not like reducing their estates. Subsequent projects have refunded entrance fees on some vesting basis (eg 1% amortizing to the facility per month of occupancy) or at flat percentage rates, and sometimes limited nursing care in return. Refunding entrance fees creates a tax problem because the refunded portion is then construed as a loan under I.R.S. rules, obligating the resident to pay taxes on imputed interest. Under a special 1985 law, residents of CCRC's are exempt from imputed interest on the first \$90,000 of the refund. A number of conditions on the facility apply.¹ The immediate effect of refunding entrance fees is to raise the price that projects must charge to meet the future refund liability. Refunding entrance fees increases the price by up to 50%. One advantage of fee structures with an initial, refundable payment is that should the resident later become indigent, the refund liability can be a source of reimbursement to the facility. When the refund is exhausted, Medicaid can be used in qualified facilities. With all fee alternatives, residents can deduct the portion of their fees that subsidize health care operations.

From the developer's perspective, entrance fees give flexibility in project financing. They can be used initially as a permanent take-out (resident financing), or they can be invested in a trust to yield revenue for debt service.

¹The resident must be entitled to lifetime tenancy, be entitled to long-term care, and begin tenancy in an independent living unit. More significant for developers are the requirements that the long-term care be provided at substantially no additional cost and that all components of the project be owned by the same entity.

A problem with the investment alternative is negative arbitrage; the debt interest rate, unless tax-exempt bonds are used, is likely to exceed the yield rate. Investing the funds also introduces the necessity for investment responsibility, which is usually a nonexistent or minor part of real estate management. A further problem with refundable entrance fees is that they create a future liability. If used as a permanent take-out, then refunds are dependent on repurchase of units. If invested, and the revenue stream is assigned to the debt service, then funds are nearly as illiquid. Furthermore, high yields usually require long-term investment which also creates illiquidity. An advantage of entrance fees is that more flexibility in revenue increases is possible; gains can be derived from entrance fee or monthly fee increases. This flexibility is subject to adequate unit turnover, of course. A tax consideration related to imputed interest is that only the *non-refunded* portion of the entrance fee is treated as current income; the rest is a loan and as such it is not subject to tax treatment as current income. Fee structures with upfront payments make it easier to lock in presales, psychologically if not legally, with 10% deposit requirements that are due with purchase and sale agreements. Preleasing in rental projects does less to prevent kick-outs.

At least one alternative to the entrance fee has been used to escape the imputed interest problem. This involves characterizing entrance fees as "memberships" and not guaranteeing repurchase but guaranteeing assistance to the purchaser in reselling it. Current lobbying efforts in Congress may succeed in raising the imputed interest threshold and render the issue moot for most projects.

2. CONDOMINIUM OR COOPERATIVE OWNERSHIP

Although common with most other housing types, condominium and cooperative fee structures are just beginning to play a role in continuing care centers. They solve several problems for residents and developers. Residents easily understand condo and usually coop types of ownership. This makes marketing considerably easier. As with an entrance fee, developers usually guarantee buyback of the unit. Residents also derive the tax advantages of home ownership, which may or may not be useful for seniors

in their seventies.² Imputed interest may not be a problem depending on I.R.S. interpretations. Condos (and coops to a lesser extent) have a greater chance of receiving financing than entrance fees. This is less significant for residents themselves, who are unlikely to finance their purchases, as for third parties such as children who may finance the purchase for the resident. If condo or coop ownership can attract younger residents by presenting the upfront fee as more of a real estate investment, it would be apparent in lower initial health care utilization.

For the developer, a condo or coop structure coupled with substantial monthly fees has several advantages. As with a rental structure, it may exempt the facility from state regulation. It is especially appropriate in instances where nursing is provided on a fee-for-service basis without subsidy by initial payments. The unit sales would normally function as a permanent take-out of construction financing, although they could be used to fund debt service. Unit repurchases are dependant on resales, and developers may make them contractually contingent on a resale. One of the biggest problems with condos or coops is how the developer can maintain operating control. If the developer is liable for unit repurchase, it will want to ensure that the facility is maintained and managed well. Furthermore, residents may not be in a position to assume operating control themselves. With condos, operating control may not be possible in states where condo owners are entitled to run owner's associations. If the project is sited on a leasehold (which may not be possible in some states), then a developer who is the lessor can exercise rudimentary control over the property through the leasehold. The leasehold may be the only ongoing revenue benefiting the developer unless it also manages the project.

Coops offer more flexibility in retaining operating control. A coop purchase conveys two interests which cannot be separated: stock in the facility corporation, and a proprietary lease on a particular unit. To maintain operating control, the stock can be issued in two classes; the developer retains the class with voting control, while residents get the class with financial benefits if any accrue. A drawback of this arrangement is that it disqualifies

²For example, \$125,000 capital gains exclusion can be deferred.

coop members for homeowning tax benefits under current I.R.S. rules. For the developer, condo sales and possibly coop sales under this structure will eliminate eligibility for depreciation of the facility.

3. THE ALL-RENTAL FACILITY

A fee structure consisting entirely of monthly fees is most common in congregates, and infrequent in CCRC's because higher costs require extremely high monthly fees. Renting leaves control of assets with the resident; the renter can invest his or her assets to generate income for the fees, rather than forfeiting the assets to the developer. Liquidity for the resident is high. A marketing drawback of rental projects, which may not be as important as the advantage of liquidity, is that most prospects are usually homeowners and renting may be viewed as step down in housing status. Renting also eliminates ownership tax advantages which may or may not be important to elderly buyers in their seventies. Marketing congregates is presumably easier with a rental structure. For CCRC's, the marketing advantages are questionable.

For the developer, a rental structure has an effect on project start up, operating risk and financing options. Rental projects are generally exempt from state regulations that apply to entrance-fee projects. The resident's control of assets introduces the danger that the assets will decline in value, requiring a financial subsidy for the resident to remain in the center. Without a refund liability due to the resident, however, such a subsidy is not readily available unless funded by a reserve. Another possibility in some locations, given the political sensitivity of rent levels for the elderly, is the imposition of rent control. With no future income coming from entrance fees or unit sales, rent control would affect revenues most with a rental structure. A rental fee structure forces the developer to secure outside, third-party financing unless it uses its own equity for all project costs.

TABLE 4-1 summarizes some of the issues discussed for each fee structure.

TABLE 4-1: CHARACTERISTICS OF DIFFERENT FEE STRUCTURES

	<u>All- Rental</u>	<u>Entrance Fee*</u>	<u>Condo*</u>	<u>Coop**</u>
<i>RESIDENT CONSIDERATIONS:</i>				
Resident retains control of assets	YES	NO	NO	NO
Familiarity/marketing advantage	YES	NO	YES	MAYBE
Lowest upfront cost	YES	NO	NO	NO
Possible financing of purchase	NO	NO	YES	MAYBE
Homeowning tax advantages	NO	NO	YES	NO
Imputed interest charges	NO	YES	MAYBE	MAYBE
<i>DEVELOPER CONSIDERATIONS:</i>				
Comprehensive state regulation	NO	MAYBE	NO	NO
Developer has operating control	YES	YES	NO	YES
Property depreciable	YES	YES	NO	MAYBE
Requires outside debt financing	YES	NO	NO	NO
Initial startup revenue	NO	YES	YES	YES
Most effective presale	NO	YES	YES	YES
Investment manage.(with trust)	NO	YES	NO	YES
Most sensitive to rent control	YES	NO	NO	NO
Some non-taxable revenue	NO	YES	MAYBE	MAYBE
Long-term liability to resident	NO	YES	YES	YES
Use of liens as financial subsidy	NO	YES	YES	YES

*With refund/repurchase obligations

**With repurchase obligation and dual stock structure

PART B: Sources of Debt Financing

Developers may finance a CCRC without permanent debt, as when they use entrance fees or unit sales for permanent take-out of construction financing ("resident financing".) But when it is necessary or decided to use permanent debt, a number of sources have historically been available for retirement centers, albeit with varying degrees of frequency. Choosing financing for a particular project, however, may not be a choice at all. Project specific constraints, such as operating income and the cost of debt, may eliminate some choices. Underwriting restrictions will eliminate other sources. Finally, as with other real estate investments, the availability of a particular type of debt centers on a key issue: how much equity the developer has or can obtain. Even when the developer has equity of its own, it probably wants to minimize its investment. When equity is not on hand, equity financing must be secured, or debt financing used that completely covers costs. The latter is usually possible only for non-profit sponsors.

The types debt available generally come from two sources: conventional mortgage financing and bonds. Bonds are available as taxable or tax-exempt instruments, and may be rated or unrated. The remainder of this chapter discusses these in greater detail.

1. CONVENTIONAL MORTGAGE FINANCING

Conventional financing from banks, savings and loans, and other financial institutions presents two major problems for congregates as well as continuing care centers: availability and equity requirements. The retirement center concept is frequently unfamiliar to lenders, and usually perceived as highly risky. Whereas bond financing reduces risk to the investors with reserve requirements and insurance, banks and savings and loans tend to avoid high risk projects altogether. Retirement centers are perceived as heavily dependent on management expertise. Lenders feel that mismanagement of marketing and operations in these "service-enriched" projects can lead to project failure more readily than with most types of real estate. Whereas normally the underlying real estate constitutes adequate collateral, the highly specialized nature of retirement centers means that they are illiquid assets in case of project foreclosure. Furthermore, the prospect of evicting elderly residents from a foreclosed project obviously discourages lenders. Some lenders may fear that courts will expand tenant rights in case of foreclosure. Some also fear rent control. Conventional lending is increasing in availability, although lenders are setting more preconditions on projects , such as presales.

Lenders will usually fund up to 70%-80% of the value of projects. Required equity on typical projects can be anywhere from \$2 million to over \$10 million, which can be syndicated by proprietary developers. The advantages of conventional financing include lower financing fees than with bonds, lower reserve funds, lower ongoing fees, and faster processing time since the loan is negotiated directly with the lender. But disadvantages are significant, including high rates relative to tax-exempt bonds and sometimes taxable bonds. A range of debt variations such as participation and convertible mortgages is theoretically possible, although in some cases project cash flow

is inappropriate for such arrangements. Chapter 7 discusses this issue further.

Another problem with conventional mortgages is that terms are usually 10-15 years. This means a risk of refinancing at higher rates.

2. BOND FINANCING

For non-profit CCRC's and congregates, the choice of debt financing is enhanced by a wide selection of taxable and tax-exempt bonds. For proprietary CCRC's, bonds are more problematic. Bonds offer an opportunity to invest relatively little equity, sometimes as little as 10% for proprietary developers or no equity for non-profits. But the price paid is high upfront fees. Bonds function as construction loans as well as permanent financing, so closing on a bond is at the commencement of construction. This means that interest must be paid on the bond during the construction period, although the bond proceeds can be invested to earn income. But in most cases the income will be less than the interest, and this negative arbitrage is an additional development cost. Bonds also require high debt service reserves, and various other reserves. They also entail issuance costs of about 1%, and unrated bonds can carry very high discount rates. These costs are funded by the bond itself, notwithstanding equity requirements, but the total debt that must be serviced rises commensurately. A project financed with an unrated bond would have considerably higher debt service than if financed with a conventional mortgage, assuming both had the same interest rate. Even with a lower debt coverage ratio, higher rents or fees would be necessary to yield adequate income for the debt service. Thus conventional mortgages would usually be the preferred financing choice but for two reasons: borrowers may not be able to meet the equity requirements, and tax-exempt bonds offer lower interest rates and longer terms.

Tax-Exempt Bonds. Although the outlook for private purpose tax-exempt bonds is questionable due to pending tax reform legislation, these bonds have recently been the most common means of financing congregate and continuing care centers. Tax-exempts are issued, but not guaranteed, by states, cities or authorities such as housing agencies. The bonds most readily

available for retirement centers are multifamily housing revenue bonds. They have been ideally suited to the non-profit sponsors who have dominated the industry, since for them the bonds can cover 100% of hard and soft costs including equipment and underwriting fees. Long-term equity is not normally required. For proprietary developers 90% of total project costs can be financed. (Underwriters, however, require substantial presales, usually 50%, which itself requires putting \$500,000-\$1,000,000 at risk.) Unrated tax-exempt bonds may have terms of up to 30 years, which is longer than unrated taxable bonds but shorter than the term available with the Federal Housing Administration (FHA) insurance program described below for congregate rentals.

When tax-exempt multifamily housing revenue bonds are used by proprietary developers, federal regulations require renting 20% of units to moderate income groups, in effect subsidizing them with the remaining 80% of units. Moderate income groups are defined as those with incomes 80% of market area medians. The precise requirements may change with tax reform. In areas with high median incomes, such as parts of California, this scarcely affects revenues of most rental projects. It also applies only to the rental portion of fees; a separate "service" fee can be charged per resident above the rent. But for proprietary CCRC's with upfront fees, the below-market units can strongly effect project financials.

Non-rated bonds are secured only by the project itself, sometimes with assignment of leases, and thus are risky in investment eyes. As such they require higher interest rates, and are bought for yield rather than for investment security. Unrated bonds are also less marketable; unless placed privately they are sold on the "junk" market. In a few instances it may be possible to privately place a bond with a local financial institution that has some interest in a project (eg community reinvestment goals.) Generally, however, to make bonds more marketable the credit of other institutions can be purchased. Credit enhancement also reduces the interest rate and the bond discount fee. Private letters of credit (LOC's) from banks or savings and loans, sometimes backed by other institutions such as insurance firms, are rarely used by themselves for retirement centers because of upfront cost and annual fees.

FHA mortgage insurance programs are less expensive and more common, although available now only to congregates and nursing homes. Section 232 programs insure nursing homes and personal care facilities. Section 221.d insures "Retirement Service Centers," defined as all rental, service-enriched projects with unit kitchens and baths, that target seniors over 70. The program requires six months of debt service to be maintained for 24 months or until stabilization. The rental stipulation excludes any continuing care project with an upfront fee, and at this time rating agencies do not rate endowment facilities although private insurance is available. The program provides insures up to 90% of proprietary project costs (Section 221.d.4) and 100% of non-profit costs (Section 221.d.3). Tax reform may redefine what total project costs may cover, which would effectively increase equity requirements. This credit enhancement program, since its 1983 introduction, has become the primary means of facilitating congregate financing. It is currently the only very long term (40 year maturity and amortization) fixed rate insurance program available for retirement centers. Disadvantages are that "prevailing" wages are required during construction, which generally means union rates, and the long processing time. Obtaining the insurance through one of the several authorized co-insurers expedites the process, but entails another fee as well as extra annual insurance premiums. To make the bonds investment-grade ratable by Standard & Poors or Moody's, a LOC is privately obtained to cover the short fall between the FHA guarantee on 99% of the debt and 100% of the debt.

Taxable Bonds. Taxable bonds have not been used frequently for retirement centers. Unrated taxable bonds carry high interest rates and usually have very short terms (eg as short as 7 years). Their amortization period is also shorter than for other types (eg 25 years). They do allow for very little equity. In instances where tax-exempt bonds are not available because of state statute, limits on issues, or cumbersome procedures, taxable bonds may be the only alternative short of conventional mortgages.

Private LOC's or the FHA insurance programs can be combined with Government National Mortgage Association (Ginnie Mae) taxable bonds to make them ratable, which results in a lower interest rate closer to that of unrated tax-exempt bonds.

Theoretically any of the fee structures outlined in Part A can be used with any of the debt types in Part B. For proprietary CCRC's, however, the below-market stipulations of tax-exempt bonds and the associated upfront expenses make them an unlikely choice. The lack of a Federal insurance program for CCRC's also makes rated tax-exempt and taxable bonds difficult to obtain. Conventional financing is most likely the debt source until further alternatives develop.

The Curriculum Vitae of a CCRC: A Case Study of "Ashford"

This chapter focuses on a proprietary CCRC now in the early development stage, pseudonymously called "Ashford" in this paper, to illustrate how one retirement-center developer has handled development obstacles and approached financing. The quantitative data about Ashford is hypothetical, representing a typical project, but closely resembles the actual facility. Based on this empirical analysis of one project, financing recommendations are made.

The chapter begins with Part A which reviews the the history of the project and its current status. Part B then concentrates on cost factors and profit centers, including the following: development costs; income and expenses streams from residential, nursing and resale operations; and future liability incurred by refund and health care obligations. The discussion on refund and nursing liability attempts to quantify the costs of these CCRC risks.

PART A: Development Decisions and Hurdles

This section presents an overview of Ashford:

- The origin of the project and the partners involved
- Determination of the program (the type of facility and services provided)
- Design decisions, cost issues and zoning approval
- Marketing considerations
- Operating considerations
- State regulation

1. BACKGROUND

Ashford will be located in metropolitan Boston, Massachusetts. It is a joint venture between three entities. One is a local non-profit health care

corporation, another a national firm with development and operating experience in acute-care hospitals and nursing homes, and the third a national developer whose main office is in the Boston area. The national health care firm has begun CCRC development elsewhere in country. Despite the involvement of the non-profit partner, Ashford is entirely planned as a proprietary, profit-making endeavor. The motivations of each partner, aside from making money, are slightly different. The non-profit health care group is interested in a facility for outplacement of certain patients who need a continuing care facility, in diversification of its activities and in a profit center that will make a contribution toward supporting its money-losing operations. The national hospital and nursing home company is interested in diversification into a related field as well as profit. The locally-based national developer was the last party to enter the deal, which the non-profit requested to provide local development experience to the team. For this developer, the project is a chance to diversify and expand its residential operations which historically have been a small part of the company.

Management of the development process and of the facility during operations is going to be shared among the entities depending on expertise in a given area. Currently the partners plan to contribute and benefit equally from Ashford. Notwithstanding a change in the deal structure and separate development and management fees, they will split equity, cash flow and tax benefits equally. (An exception to this has been the purchase of land by the national health-care firm.) Tax benefits may be minimal after the 1986 tax reform, but two of the partners have relatively little need for tax benefits anyway. The non-profit cannot use them, and the national health care developer is a publicly traded firm for which paper losses can depress reported net income. The third firm is a private partnership which can benefit the most from tax shelter. The project at this point is proceeding on the basis of pretax, "economic" considerations only, with no major decisions based on tax effects on the joint venture.

2. DETERMINING THE PROGRAM

From the start Ashford was planned as a continuing care facility with nursing services rather than some other type of elderly housing such as a congregate.

The health care experience of two of the joint venture partners obviously influenced this decision. The site chosen is an 80-acre parcel surrounded by an established, relatively affluent area. A market analyst suggested a relatively deep market for continuing care because Massachusetts currently has few CCRC's. While some "Rustbelt" cities, such as Philadelphia and Minneapolis, have many facilities which make competition a major factor in feasibility, the partners felt that the dearth of competition in Boston would make it easy to reach a capture rate of the eligible market that would sustain the project, about 1%-3%. Allowing for some competition, this is lower than the 5% overall capture rate considered realizable. Prices will make Ashford an upscale project affordable to the upper middle class, with qualifying income at about \$25,000 per year plus unit prices well over \$100,000. While such economic status is far above the norm in national terms (see Chapter 2), it is less unusual in the affluent market area surrounding the project. Massachusetts has three operating CCRC's, one of which is close to Ashford and now has at least a three-year waiting list after opening in 1984. Two proprietary congregates also exist. Several new CCRC's are in very early development stages, but the developers expect, with characteristic optimism, to have the competitive edge for about five years.

In the hypothetical model of Ashford, there are 270 independent living units (ILU'S), 30 assisted living units (ALU'S) and a 60-bed nursing center. The developers do not plan future expansion of the 300 living units, although eventually they will expand the nursing center to 120 beds contingent on various approvals. Thus unlike the nursing centers in many CCRC's, this one is intended to serve a large proportion of outside patients indefinitely. The living units are to be built in two phases, with construction on the second phases commencing about two years after construction on the first. This should reduce construction financing costs, allow savings by building some common amenities after initial sales, and allow better utilization of the assisted care units which will not be built until the second phase. This paper will not focus on the phasing in order to better compare financing alternatives.

For marketing and in some cases regulatory reasons, the developers have decided to offer the fullest selection of services generally found in CCRC's.

Entrance will guarantee unlimited nursing care without additional charge, and other health services will include health maintenance such as "wellness" programs. Standard fees will also include the typical meal services, housekeeping, linen, activities, and transportation. The main option will be additional meals beyond the one daily meal included in the monthly fee.

3. GETTING OFF THE GROUND: DESIGN DEVELOPMENT, COST CONTROL AND ZONING APPROVAL

Ashford is now in design development with a team that includes a consultant in elderly housing in addition to the architectural firm. Much effort is going into determining the visual character of the facility. A goal of the developers is to achieve a non-institutional, residential character similar to a small resort hotel which will give Ashford a marketing edge. The design is also taking into account the special social and physical needs of the elderly. From a cost and financing standpoint, a key design consideration is the amount of common area and the mix of unit types. The table below shows the overall size of the facility, not including the nursing center. (Full space analysis is APPENDIX TABLE 1.)

TABLE 5-1: ASHFORD SIZE

	<u>Units</u>	<u>Mix</u>	<u>Total Sq Ft</u>
ILU's	270	90%	232,875
ALU's	<u>30</u>	<u>10%</u>	<u>13,500</u>
<i>Total</i>	300	100%	246,375
Common Area			30,450
Circulation (20%)			<u>55,365</u>
<i>Total Area</i>			332,190

In the mix there are no studio-sized ILU's and there is a 50% proportion of 2 bedroom units. The high number of two bedrooms reflects a marketing decision, based in part on the experience of the nearby CCRC, that larger units are the best sellers. No studios will be offered except for ALU's. One effect of this high proportion is to increase building profit, since the two bedroom units carry a higher profit per square foot.

The common area includes lounges, a library, a clubroom, a conference room and auditorium; concessions such as a convenience store and a beauty shop; craft and exercise areas; and administrative, dining and housekeeping facilities. With circulation, these add about 36,000 square feet to the project (11% of total area), or over \$2 million in construction costs. The nursing center occupies additional area, nearly as large as the common amenities.

The site, although large, has relatively few buildable acres, at most 25% of the total. Difficult site conditions, due in part to steep grade, will mandate high site improvement costs. Since most of the site is unbuildable, it will be dedicated to conservation usage, for which the developers will receive tax benefits as with a charitable contribution. While access would be easiest from an adjacent office parcel, a marketing decision to access the site through a residential area will also raise site costs by requiring additional road construction. The developers have obtained special zoning for the project, which was zoned for commercial usage. The commercial zoning was amended to include the CCRC mix of institutional and residential uses. Parking spaces will be built at a ratio of about half a space per unit. Because the project is proprietary, it will pay full real estate taxes, and the developers stressed this consideration when seeking the zoning amendment.

4. CLOSING THE DEAL: MARKETING PROGRAM

Ashford will be an upfront fee project (ie, it will require an entrance fee or unit purchase), and the developers have set an goal of 50% presales during the preconstruction period of eight to twelve months. Given the slow absorption rates of retirement centers, this pace of sales seems extremely ambitious. From a cost standpoint, it also requires a large outlay of equity which will be "at risk." Until now, funds spent for design schematics and zoning changes have come out of a small startup fund, and a further \$1.6 million has been spent on land. During the preconstruction period, however, considerable soft cost expenditure will be necessary for such items as architecture and engineering commissions, legal and consulting fees, development fees and taxes. (These are assumed to be over \$1.7 million in the proforma.) At Ashford, the developers expect to be able to finance some of this. But in a typical project, several million dollars (including land costs

and startup fund) would be necessary in at-risk equity before presales reach the 50% hurdle level and construction financing assumes payment of costs. Beginning the presales campaign earlier before the preconstruction period would reduce the riskiness of these funds. In other projects, the initial equity could also be syndicated to transfer risk to investors.

Some final decisions about the project remain to be made before marketing can begin. A key one is what form of ownership the project will offer. Initially planning an entrance fee project, currently the developers favor a cooperative ownership structure to improve marketability for the reasons discussed in Chapter 4 and for regulatory reasons. The fee levels would not change with this ownership structure, although the change has financial consequences for both the developers and the residents.

5. REDUCING OPERATING RISKS: REFUNDS AND NURSING

Refunds. The two major operating risks discussed in Chapter 3 are unpredictability in the turnover and the nursing utilization rates. Ashford's developers have tentatively decided to make unit refunds or repurchases conditional on "availability of funds." This means that when a resident dies or decides to leave, return of the refundable portion of his or her purchase price (tentatively set at 90%) will be contingent on resale of the property, or on availability of facility funds held in a reserve or trust. This may hurt marketability of the project if prospects feel that resales will be difficult in the future. Resale sluggishness cannot be ruled out; while current facilities have long waiting lists, future competition could drive the CCRC resale market closer to the softness of the condominium resale market that exists in many overbuilt areas. Another danger is that prices could deflate to make full return of funds difficult even with resale. Establishing a high reserve fund could resolve fears of repayment, but no matter how high the fund it would be subject to volatile turnover. For example, an economically feasible fund could not cover a mass exodus of residents. The marketing drawback of not guaranteeing repurchase or refund is only a *potential* drawback, however. If prospects do not have a long-term outlook or if they trust the developers, it may not materialize at all. For the developers, not guaranteeing return of funds substantially lessens future liability. The

reduction in risk may make financing sources more forthcoming. The tradeoff is that marketability may decline and hurt sales.

Nursing Care. The other major uncertainty particular to continuing care operations is the potential volatility of nursing care utilization. At Ashford, the developers could not reduce risk as other operators have by limiting the nursing care guarantee. To obtain the Massachusetts Determination of Need (DON) certificate for the nursing center, it was necessary to guarantee the nursing care at no additional cost (see State Regulation section below). Furthermore, with an entrance fee structure (not a cooperative), limiting nursing care would risk loss of the Federal imputed interest exemption.

Tentative prices for Ashford have not been arrived at in part or whole with actuarial analysis, at levels that will fund the present value of future actuarial liability. Rather the developers have set prices based wholly on real estate criteria: a markup on construction costs and competitive rates. The developers thus have two options to subsidize nursing care, short of subsidizing it out of their own outside funds: they can make the project self-insuring, or they can secure long-term care insurance. Initial inquiries into the cost of long-term care insurance have found exorbitant rates, with companies asking for approximately 10% of unit price as an upfront payment, and then premiums of about \$100 per month per unit. This is far more than the projected cost for a community to subsidize residents under typical utilization rates. Until long-term care insurers offer better prices, self-insurance is the likely option. Its financial effects are reviewed in Part B.

The ability to charge residents more for assisted care if they need it in their unit or must move to an ALU is also hindered by guaranteeing care. Long-term care insurance may cover assisted living, which otherwise is another additional liability the developers must fund.

6. STATE REGULATION

Current Massachusetts restrictions on nursing home approval effectively required guaranteeing nursing care. The developers received a DON under a

special stipulation modifying the process required of CCRC nursing centers to obtain the certificate. In turn, the stipulation required the developers to guarantee nursing care and build a maximum of one nursing bed per five living units (this is the ratio at Ashford). Otherwise the developers could offer nursing services unbundled and eliminate much future liability. Massachusetts does not now have comprehensive regulations on continuing care centers themselves, although extensive legislation has been introduced in the statehouse. Because the state does regulate condominiums and does not regulate cooperatives in matters such as resident control, the use of a coop structure at Ashford is more likely. Another state law requires that deposits be held in escrow until closing. This prevents the developer from spending the 10% deposits on construction before occupancy.

PART B: Breaking Out the Profit Centers

In a continuing care facility, there are five areas of development and operations that potentially can generate profit for the developer:

1. Startup profits from selling units initially above cost.
2. Profits from reselling the units when they are vacated in the operating life of a project.
3. Profits from operation of the housing units.
4. Profits from operation of the nursing center.
5. Income paid as development and management fees.

This paper will consider ways for proprietary developers to achieve a sufficient return on startup, resale, residential and nursing operations with minimal risk to themselves *and* the residents of the facility. It will not consider developers' return from development and management fees, which should be constant between financing alternatives. (At Ashford the three joint venturers will share the development fee and the national health care firm will hold the management contract.) The financial projections do consider these fees in cost and expense assumptions.

As a preamble to discussing the financing options in Chapter 6, this section will present the cost and expense data underlying the financial projections for

the project. The data shown here comes from the resident financing option, whereby upfront fees permanently take out the construction loan, but it generally applies to all the financing options. First it will present the relatively routine items of development cost and residential operations. Then, it will analyze in greater depth the complex areas of resales and nursing in terms of revenues, expenses and future liabilities.

1. STARTUP REVENUES

The basis of fees in most CCRC's, except for those which are all rental facilities, is for upfront purchase prices to cover the cost of construction, and monthly fees to cover operating costs. Upfront costs may also be used for a reserve or trust to fund future contingencies.

Ashford's projected total sales volume is \$45,825,000, with an average sales price of \$152,750. Monthly fees range from \$900 to \$1500, with an average of \$1128 not counting double occupancy fees. Annual monthly fee revenue is \$4,059,000. The breakdown by unit type is as follows:

TABLE 5-2: ASHFORD PRICES

	<u>Number</u>	<u>Monthly Rent</u>	<u>Price</u>	<u>Annual Fee Revenue</u>	<u>Sales Volume</u>
<i>INDEPENDENT UNITS:</i>					
ILU 1 BR A	60	\$900	\$125,000	\$648,000	\$7,500,000
ILU 1 BR B	75	\$1000	\$140,000	\$900,000	\$10,500,000
ILU 2 BR A	75	\$1150	\$175,000	\$1,035,000	\$13,125,000
ILU 2 BR B	60	\$1300	\$195,000	\$936,000	\$11,700,000
<i>SUBTOTAL</i>	270			\$3,519,000	\$42,825,000
<i>ASSISTED UNITS:</i>					
ALU STUDIO	30	\$1500	\$100,000	\$540,000	\$3,000,000
<i>TOTAL</i>	300			\$4,059,000	\$45,825,000
<i>AVERAGE</i>		\$1128	\$152,750		

The total sales revenue includes a 17% gross margin, reflecting development costs of \$38,015,207 with the resident-financed alternative, a figure that changes with other alternatives to reflect construction financing and origination fees. (See APPENDIX TABLE 2 for detailed costs.) The structure cost of \$60.00 per square foot reflects commercial quality construction, high cost items such as elevators, and special design for seniors.

The nursing center cost is regulated by the state and is a separate line item costing \$2,485,000. The development costs *per se* do not include startup operating deficits, reserve funding or nursing insurance funding (if any), since these are calculated in the returns for their respective profit centers.

Equity requirements vary with the financing alternatives. With resident financing, there is no long-term equity requirement because there is a gross building profit. However, costs in the startup year are over \$4 million, and this constitutes equity until returned by unit sales.

2. RESIDENTIAL OPERATIONS

Since Ashford will probably be a cooperative with developer control, operations cash flow can accrue to the developer. Aside from the monthly fee income, revenues of the residential units are supplemented by a double occupancy fee of \$350 per month for every second occupant of an apartment. An average of 25% of the units are assumed to have two occupants. Expenses for residential operations fall under three components: staffing, operating, and dining. Staffing includes all facility personnel except those in dining service and the nursing center (whose expenses are not included here). About forty full-time equivalents are assumed in this category for Ashford. Dining includes all meal-related expenses calculated at a fixed rate per person, per day. Operating expenses are fixed, physical plant costs, with the exception of the management fee which is tied to effective operating revenue. The total for each category, per unit, is below (see APPENDIX TABLE 3 for detailed breakdown).

RESIDENTIAL EXPENSES PER UNIT, YEAR 1*	
Staffing	\$200
Operating	\$468
Dietary	<u>\$228</u>
Total	\$897
Average Rent	\$1215

* With 100% occupancy

The expenses do not show the cost of the nursing subsidy or long-term care insurance, which eventually can use up a large portion of the per unit surplus indicated. TABLE 5-3 is a complete residential operations proforma.

TABLE 5-3: PROJECTED BEFORE TAX CASH FLOW---RESIDENTIAL OPERATIONS (RESIDENT-FINANCING)

YEAR:	INFLATION	1	2	3	4	5	6	7	8	9	10	11	12
INCOME:													
1	ILU'S	0.0%	3,519,000	3,519,000	3,519,000	3,519,000	3,519,000	3,519,000	3,519,000	3,519,000	3,519,000	3,519,000	3,519,000
2	ALU'S	0.0%	540,000	540,000	540,000	540,000	540,000	540,000	540,000	540,000	540,000	540,000	540,000
			4,059,000	4,059,000	4,059,000	4,059,000	4,059,000	4,059,000	4,059,000	4,059,000	4,059,000	4,059,000	4,059,000
3	DOUBLE OCCUPANCY	0.0%	315,000	315,000	315,000	315,000	315,000	315,000	315,000	315,000	315,000	315,000	315,000
4	SERVICE FEE	0.0%	0	0	0	0	0	0	0	0	0	0	0
5	MISC INCOME	0.0%	36,000	36,000	36,000	36,000	36,000	36,000	36,000	36,000	36,000	36,000	36,000
			351,000	351,000	351,000	351,000	351,000	351,000	351,000	351,000	351,000	351,000	351,000
6	POTENTIAL OPERATING REVENUE		4,410,000	4,410,000	4,410,000	4,410,000	4,410,000	4,410,000	4,410,000	4,410,000	4,410,000	4,410,000	4,410,000
7	VACANCY	70.0%	70.0%	22.5%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
8	LESS VACANCY		(3,087,000)	(992,250)	(220,500)	(220,500)	(220,500)	(220,500)	(220,500)	(220,500)	(220,500)	(220,500)	(220,500)
9	EFFECTIVE OPERATING REVENUE		1,323,000	3,417,750	4,189,500	4,189,500	4,189,500	4,189,500	4,189,500	4,189,500	4,189,500	4,189,500	4,189,500
10	INTEREST INCOME		0	0	80,000	80,000	80,000	80,000	80,000	80,000	80,000	80,000	80,000
11	TOTAL REVENUE		1,323,000	3,417,750	4,269,500	4,269,500	4,269,500	4,269,500	4,269,500	4,269,500	4,269,500	4,269,500	4,269,500
EXPENSES:													
12	NURSING SUBSIDY		(297,327)	(339,204)	(381,081)	(422,958)	(464,835)	(506,712)	(548,589)	(590,466)	(632,343)	(674,220)	(716,097)
13	PLUS VACANCY		208,129	76,321	19,054	21,148	23,242	25,336	27,429	29,523	31,617	33,711	35,805
14	STAFFING	0.0%	(432,789)	(721,315)	(721,315)	(721,315)	(721,315)	(721,315)	(721,315)	(721,315)	(721,315)	(721,315)	(721,315)
15	OPERATING	0.0%	(1,685,328)	(1,685,328)	(1,685,328)	(1,685,328)	(1,685,328)	(1,685,328)	(1,685,328)	(1,685,328)	(1,685,328)	(1,685,328)	(1,685,328)
16	PLUS VACANCY		438,019	59,535	13,230	13,230	13,230	13,230	13,230	13,230	13,230	13,230	13,230
17	DIETARY	0.0%	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)
18	PLUS VACANCY		574,875	184,781	41,063	41,063	41,063	41,063	41,063	41,063	41,063	41,063	41,063
19	TOTAL OPERATING EXPENSES		(2,015,671)	(3,246,460)	(3,535,627)	(3,575,411)	(3,615,194)	(3,654,977)	(3,694,760)	(3,734,543)	(3,774,326)	(3,814,109)	(3,853,893)
20	REPLACE. RESERVE @	1.50%	(66,150)	(66,150)	(66,150)	(66,150)	(66,150)	(66,150)	(66,150)	(66,150)	(66,150)	(66,150)	(66,150)
21	NET OPERATING INCOME		(758,821)	105,140	667,723	627,939	588,156	548,373	508,590	468,807	429,024	389,241	349,457
22	DEBT SERVICE												
23	PARTICIPATION												
24	BEFORE TAX CASH FLOW		(758,821)	105,140	667,723	627,939	588,156	548,373	508,590	468,807	429,024	389,241	349,457

NOTES:

- 3 Figured at average double occupancy rate stated in assumptions. Actual rate would decline as community matures.
- 10 Total of reserve and trust income shown in TABLE 4.
- 12 From nursing subsidy in table TABLE 5. Also assumed equal to insurance premium if long term care insurance premium used.
- 13 Based on vacancy rate in Line 7
- 14 Staffing Year 1 only adjusted for vacancy (load of twice occupancy rate)
- 16 Vacancy on management fee only, except Year 1 where also adjusted for 50% of occupancy
- 18 Based on vacancy rate in Line 7
- 20 Figured on potential operating revenue

Occupancy. The financial projections assume that 60% of the units are occupied by the end of the first year of operations, another 35% by the end of the second year, and stabilized vacancy of 95%. (Assuming a balanced rate of move-in during a given year, average occupancy rates are 30%, 77.5% and 95% respectively.) These years of initial operation follow two years of presales during startup and initial construction, which continues into the first year of operations(Year 1). As with most real estate development, the startup risk that full occupancy will be prolonged is present. However, this startup risk is not examined except where particular financing structures are particularly susceptible to it. Not counting interest income and the nursing subsidy, breakeven occupancy and the operating expenses ratio are both 75%. With the nursing subsidy, they are 86%.

Inflation. In most of the analysis no inflation is assumed in order to analyze the economic effects of items such as nursing subsidies that inflation might hide. However, other scenarios with inflation are examined in sensitivity analysis. Three kinds of inflation are considered to show varying effects on the project in this analysis. *Income inflation* applies to all income except upfront fees. *Expense inflation* applies to all operating expenses. *Price inflation* applies to upfront fees; in effect it is the appreciation rate of the units.

3. RESALE REVENUE AND REFUND LIABILITY

Unlike typical condominiums or other for-sale housing, in CCRC's the developer remains involved with sales after the initial sell-out. This creates potential for profit but also potential future liability, which is a major risk of CCRC's. Within the resale arena, two variables determine financial impact: turnover rates and repurchase policy. For residents, the objective is to ensure that funds are likely to be available to pay for a refund, if in fact fees are returned at all. This section will discuss resales at Ashford and how they affect financial returns.

Turnover. The rule of thumb for CCRC's, which is assumed in the analysis, is that turnover will increase one percentage point a year until stabilizing at about 8% in the eighth year. While this assumption may

underestimate turnover, especially in the early years, in being conservative it does not exaggerate the return developers can gain from resales. In the likelihood of price inflation, nominal returns would also be greater than without inflation since sales volume would be larger. Should *deflation* of entrance fee prices occur, however, increased turnover diminishes returns and causes risk if refunds are due, as discussed in the Refund Policy section below. TABLES 5-4 and 5-5 show resale income with no price inflation and with 5% inflation respectively.

Without inflation, turnover volume reaches \$3,666,000 when it stabilizes, or 8% of the original sales volume. With a 90% refund rate, 10% of this volume accrues to the developer as *current income*, and the rest reverts to former residents. (The developer's return is in fact slightly lower because units must be refurbished, which is not expensed in the proforma.) In inflationary times a spread develops that generates *excess proceeds*. The distinction between current income and excess proceeds derives from the fact that excess proceeds are a future liability payable to residents. Current income receives tax treatment as such, and excess proceeds in some instances are characterized as loans to the developer. In these respects the distinction is an accounting one. However, the developer may use the two types of income quite differently. In TABLE 5-5 the excess proceeds accrue to the reserve to help its value keep up with inflation. (Incidentally, in this proforma the reserve interest is assigned to residential operations cash flow. It could revert to the reserve to further boost its real value.)

Since the developer cannot control turnover based on morbidity and mortality for the most part (as opposed to turnover resulting from poor management), it is risky to count on high turnover rates to eventually yield profit or fund reserves. An additional factor, not analyzed, is that turnover of the assisted care units may be much higher than the rest of the living units.

Refund Policy. The developers of Ashford plan to refund 90% of the initial purchase price when residents die or decide to leave. This is becoming a standard industry figure. The refund at Ashford, however, will not be guaranteed by the developers. Should no money be available from within the CCRC for refunds, this policy will mitigate risk of future liability on a

TABLE 5-4: PROJECTED RESALE INCOME---0% PRICE INFLATION

YEAR:	NFLATION	1	2	3	4	5	6	7	8	9	10	11	12
1 POTENTIAL VALUE	0.0%	45,825,000	45,825,000	45,825,000	45,825,000	45,825,000	45,825,000	45,825,000	45,825,000	45,825,000	45,825,000	45,825,000	45,825,000
2 TURNOVER	0.0%	0.0%	1.0%	2.0%	3.0%	4.0%	5.0%	6.0%	7.0%	8.0%	8.0%	8.0%	8.0%
3 TURNOVER VALUE		0	458,250	916,500	1,374,750	1,833,000	2,291,250	2,749,500	3,207,750	3,666,000	3,666,000	3,666,000	3,666,000
4 REFUND % DISCNT @	0.0%	90.0%	90.0%	90.0%	90.0%	90.0%	90.0%	90.0%	90.0%	90.0%	90.0%	90.0%	90.0%
5 REFUNDS DUE		0	(412,425)	(824,850)	(1,237,275)	(1,649,700)	(2,062,125)	(2,474,550)	(2,886,975)	(3,299,400)	(3,299,400)	(3,299,400)	(3,299,400)
6 RESALE PROCEEDS		0	45,825	91,650	137,475	183,300	229,125	274,950	320,775	366,600	366,600	366,600	366,600
7 RESALE INCOME @	10.0%	0	45,825	91,650	137,475	183,300	229,125	274,950	320,775	366,600	366,600	366,600	366,600
8 EXCESS PROCEEDS		0	0	0	0	0	0	0	0	0	0	0	0
9 RESERVE FUND	1	0	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000
10 RESERVE INCOME @	8.0%	0	0	80,000	80,000	80,000	80,000	80,000	80,000	80,000	80,000	80,000	80,000
11 TRUST VALUE	tog off	0	0	0	0	0	0	0	0	0	0	0	0
12 TRUST INCOME @	8.0%	0	0	0	0	0	0	0	0	0	0	0	0
13 PV RESERVE/TRUST YEAR 10 @	0.0%	1,000,000											

TABLE 5-5: PROJECTED RESALE INCOME---5% PRICE INFLATION

YEAR:	NFLATION	1	2	3	4	5	6	7	8	9	10	11	12
1 POTENTIAL VALUE	5.0%	45,825,000	48,116,250	50,522,063	53,048,166	55,700,574	58,485,603	61,409,883	64,480,377	67,704,396	71,089,615	74,644,096	78,376,301
2 TURNOVER	0.0%	0.0%	1.0%	2.0%	3.0%	4.0%	5.0%	6.0%	7.0%	8.0%	8.0%	8.0%	8.0%
3 TURNOVER VALUE		0	481,163	1,010,441	1,591,445	2,228,023	2,924,280	3,684,593	4,513,626	5,416,352	5,687,169	5,971,528	6,270,104
4 REFUND % DISCNT @	-5.0%	90.0%	85.5%	81.2%	77.2%	73.3%	69.6%	66.2%	62.9%	59.7%	56.7%	53.9%	51.2%
5 REFUNDS DUE		0	(411,394)	(820,731)	(1,228,019)	(1,633,265)	(2,036,477)	(2,437,663)	(2,836,830)	(3,233,987)	(3,225,902)	(3,217,837)	(3,209,792)
6 RESALE PROCEEDS		0	69,769	189,710	363,426	594,758	887,803	1,246,930	1,676,796	2,182,365	2,461,268	2,753,691	3,060,312
7 RESALE INCOME @	10.0%	0	48,116	101,044	159,144	222,802	292,428	368,459	451,363	541,635	568,717	597,153	627,010
8 EXCESS PROCEEDS		0	21,652	88,666	204,282	371,956	595,375	878,471	1,225,433	1,640,730	1,892,551	2,156,538	2,433,301
9 RESERVE FUND	1	0	1,000,000	1,088,666	1,292,948	1,664,904	2,260,279	3,138,750	4,364,183	6,004,913	7,897,464	10,054,002	12,487,304
10 RESERVE INCOME @	8.0%	0	0	87,093	103,436	133,192	180,822	251,100	349,135	480,393	631,797	804,320	998,984
13 PV RESERVE/TRUST YEAR 10 @	10.0%	5,295,836											

NOTES:

All refunds based on 90% refund of purchase price

- 1 Represents market value of all fees in the aggregate
- 2 Based on turnover rates and growth stated in assumptions, TABLE 1. Maximum is 8% per year.
- 4 Decreasing percentage reflects appreciation of units which accrues to facility. Percentages based on future value of original (90%) discounted at the rate shown (the negative of the appreciation rate). THIS OVERESTIMATES THE EXCESS PROCEEDS because it does not take account of more recent purchases. A adjustment factor was applied to reach the figures in the text.
- 6 Difference between turnover value and refunds due
- 7 Represents portion of turnover value which will not be refundable, and is current income
- 8 Difference between resale proceeds and resale income. Accrues to reserve fund or trust unless otherwise stated
- 11 Represents initial market value of retained fees plus excess proceeds
- 13 Discount rate matches rate of entrance fee inflation inflation

recourse basis to the developer (or partnership) that would result with deflation or a soft resale market. As a consequence the policy allows potential profit from resales with no downside risk. The only cost to the developer is marketability, and by no means is it certain that marketability will even be adversely affected because of pent-up demand and a tendency among homebuyers to ignore the possibility of deflation. Non-guarantees do not release the developer from the obligation to use facility funds if available.

With or without a guarantee, the objective is to structure the facility to fund its own obligations. It is incumbent upon developers to structure financing to avoid lack of funds, even if they judge the possibility of deflation and slow resale to be minimal. The risk that deflation or slow resale will actually make available funds insufficient to repay residents depends on the rate of resale, type of financing used, whether a trust or reserve big enough to cover losses exists, and whether the trust's liquidity is adequate to permit payout or not. No reserve or trust amount would be adequate to cover all contingencies, such as a large exodus of residents who need refunds simultaneously when units cannot be sold immediately. (Even guarantees by developers are unlikely to be sufficient with such extraordinary circumstances; few developers could sustain commitments of tens of millions of dollars.) Sections on specific financing techniques will discuss the liquidity problem. First, an attempt to quantify potential liability resulting from deflation or slow resale is presented below.

The table below shows the present value, discounted at 10%, of resale current income at a range of refund percentages and inflation rates, with and without guarantee of repayment by the developer. Standard levels of turnover (see Turnover section above) are assumed. Failure to resell units is not analyzed specifically, but in effect deflation simulates this to some extent. When there is no disinflation, current income is the same with and without the guarantee.

TABLE 5-6: EFFECT OF INFLATION AND REFUND RATE ON RESALE CURRENT INCOME NPV* (000's)

WITH REFUND GUARANTEE
WITHOUT REFUND GUARANTEE

Refund Rate	Price Inflation					
	<u>-4.0%</u>	<u>-2.0%</u>	<u>0.0%</u>	<u>2.0%</u>	<u>4.0%</u>	<u>6.0%</u>
80.0%	(296)	895	2,321	2,654	3,035	3,472
	291	895	2,321	2,654	3,035	3,472
85.0%	(870)	316	1,741	1,990	2,276	2,604
	123	416	1,741	1,990	2,276	2,604
90.0%	(1,444)	(262)	1,161	1,327	1,518	1,736
	36	133	1,161	1,327	1,518	1,736
95.0%	(2,018)	(841)	580	663	759	868
	4	17	580	663	759	868
100.0%	(2,592)	(1,420)	0	0	0	0
	0	0	0	0	0	0

* Discount rate 10%.

The loss with deflation must be absorbed by the CCRC (or by the developer if there is a recourse guarantee) if refunds are to be honored. Using an 8% discount rate to match interest on a reserve, this suggests that a reserve fund of roughly \$1.75 million could be established to fund a worst-case deflation of 4% at a 90% refund rate *provided all units are resold*. (Funds for other contingencies would be additional.) In the same scenario *without* resales of vacated units, the liability could balloon. Nor do these figures take into account potential volatile turnover, which could increase losses on refunds. Estimating the liability for refunds more precisely should ideally be done on an actuarial basis, or at least based on empirical data from a large sample of projects. It should estimate turnover volatility in conjunction with inflationary and deflationary expectations. Legislation pending in Massachusetts would require a reserve several times the assumed \$1 million level. Data on the effect of inflation and deflation on turnover behavior, if any, would help in estimating refund liability.

TABLE 5-6 suggests, however, that liability and returns are relatively more sensitive to refund amounts than inflation, given identical turnover rates. Should developers decide to offer refunds, as all probably will, this analysis suggests that decreasing the refund amount to 80% than doubles the present value of resale current income, while increasing inflation from 0% to 6% per

year only raises the present value by about half. More flexibility in setting or varying the refund rate, rather than accepting the emerging industry norm of 90%, would reduce exposure to deflation. The traditional method with non-profit CCRC's was to amortize the entrance fee over a period of years until no refund was due. This significantly lowered the liability and allowed lower fees. With a lower refund rate, liability for refunds would be considerably more manageable out of facility funds, in combination with the income only from a modest reserve.

The above discussion examines the downside risk of refund policy if deflation or slow resales develop. Potentially, *with* price inflation, a windfall will accrue in excess proceeds. The present value of excess proceeds at a 90% refund rate ranges from approximately \$1.2 to \$5.6 million with price inflation of 2% to 8% respectively (without inflation, there are no excess proceeds). Slightly less than a third of this return is from interest earned on the proceeds (assuming they are returned to a reserve). While this appears to be an obvious source for funding liability, it is dependent on appreciation and therefore risky. A minimally adequate reserve should be funded with a more assured source, probably at startup. The excess proceeds might be assigned to two uses or a combination of the two:

- As income to the developer, in part to give a return on increased initial reserve funding
- As a supplement to the reserve to help maintain its inflation-adjusted value

With a lower refund rate, a proportion of excess proceeds converts to current income and may no longer be a major factor.

Determining the refund policy depends, aside from actuarial input, on marketability factors and expectations of inflationary behavior. The CCRC developer must weigh the benefits of reduced liability against the cost of a probable decline in marketability accompanying a lower refund. When deflation is considered a real risk, such marketability costs may be worthwhile. The dangers of deflation or soft resale also indicate the necessity to price the project carefully at the outset. A heavy marketing

effort at startup might sustain above-market prices. But if prices decline over the long-term, so will profitability.

4. NURSING REVENUE AND LIABILITY

If resale operations offer a likely chance for profit and some risk for liability, nursing operations offer a likely chance for profit and *certain* liability. The profit a nursing center the size of Ashford can yield is unlikely to cover the cost of the subsidy needed to provide guaranteed nursing care. If nursing care is guaranteed, then developers can expect increasing utilization and expenses until stabilization, with the potential for volatility before and after stabilization. To be able to meet the cost, the developer can either prepay with insurance or a reserve, or set project cash flow to be sufficient to pay nursing subsidies as they arise.

The Ashford nursing center is a 60-bed facility with projected annual potential revenues (taking account of Medicaid beds) of \$1,551,000. It has its own mortgage. After vacancy, expenses and debt service, projected cash flow is \$66,865 with a breakeven ratio of 91%. The 5% vacancy is somewhat deliberate; some beds must be maintained for temporary use by residents. Stabilized return on equity is 27%. TABLE 5-7 show the nursing center's 12-year proforma.

The nursing subsidy is calculated on the nursing center proforma but expensed to residential operations because funds for the subsidy come from revenues generated by residential operations. The subsidy is in effect debited internally from residential operations to the nursing center revenues. The estimated amount of the subsidy at Ashford has not been determined by the developers; it is subject to considerable uncertainty, and they have commissioned a study to estimate nursing utilization. Estimates on this proforma are based on temporary usage of nine beds and permanent usage of from five to 40 beds over 12 years. In terms of expenditure, the estimates range from \$297,327 to \$757,974 without inflation.

TABLE 5-7: PROJECTED NURSING CENTER BEFORE TAX CASH FLOW---NURSING CENTER

YEAR:	INFLATION	1	2	3	4	5	6	7	8	9	10	11	12
1 GROSS POT REVEN	0.0%	1,551,000	1,551,000	1,551,000	1,551,000	1,551,000	1,551,000	1,551,000	1,551,000	1,551,000	1,551,000	1,551,000	1,551,000
2 VACANCY		25.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
3 LESS VACANCY		(387,750)	(77,550)	(77,550)	(77,550)	(77,550)	(77,550)	(77,550)	(77,550)	(77,550)	(77,550)	(77,550)	(77,550)
4 EFFECTIVE GROSS REVENUE		1,163,250	1,473,450	1,473,450	1,473,450	1,473,450	1,473,450	1,473,450	1,473,450	1,473,450	1,473,450	1,473,450	1,473,450
5 EXPENSES:	0.0%	(978,350)	(1,151,000)	(1,151,000)	(1,151,000)	(1,151,000)	(1,151,000)	(1,151,000)	(1,151,000)	(1,151,000)	(1,151,000)	(1,151,000)	(1,151,000)
6 NET OPERATING INCOME		184,900	322,450	322,450	322,450	322,450	322,450	322,450	322,450	322,450	322,450	322,450	322,450
7 DEBT SERVICE		(255,585)	(255,585)	(255,585)	(255,585)	(255,585)	(255,585)	(255,585)	(255,585)	(255,585)	(255,585)	(255,585)	(255,585)
8 BEFORE TAX CASH FLOW		(70,684)	66,865	66,865	66,865	66,865	66,865	66,865	66,865	66,865	66,865	66,865	66,865
9 SUBSIDY % TEMP	0.00	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%	15.0%
10 SUBSIDY % PERM	2.70	4.2%	6.9%	9.6%	12.3%	15.0%	17.7%	20.4%	23.1%	25.8%	28.5%	31.2%	33.9%
11 TOTAL % SUBSIDY		19.2%	21.9%	24.6%	27.3%	30.0%	32.7%	35.4%	38.1%	40.8%	43.5%	46.2%	48.9%
12 SUBSIDY		(297,327)	(339,204)	(381,081)	(422,958)	(464,835)	(506,712)	(548,589)	(590,466)	(632,343)	(674,220)	(716,097)	(757,974)

NOTES:

- 1 Includes subsidy. Actual cash potential revenue is less subsidy
- 5 Expenses Year 1 based on 85% load
- 9 Represents percent of potential revenues lost because residents occupy nursing beds temporarily. A temporary resident requires a 100% subsidy per bed. Percent is based on assumption of nine beds (15%) used by residents initially. This figure based on Lavanthol & Horwath survey data and projections of a Boston area CCRC. Growth rate is in percentage points.
- 10 Represents percent of potential revenues lost because residents occupy nursing beds permanently. A permanent resident is assumed to require a 50% subsidy per bed. Percent is based on assumption of five beds (4.2% after 50% discount) used by residents initially. This figure based on Lavanthol & Horwath survey data and projections of a Boston area CCRC.
- 12 From Line 11(Total % Subsidy) * Line 1 (Gross Potential Revenues)

When the subsidy is treated as "self-insurance" in this manner---ie, paid for from project revenues---it markedly affects cash flow. (See TABLE 5-3) The subsidy causes real residential operations cash flow to deteriorate over the maturation period, although *after* the 12 years, if not sooner, the subsidy and cash flow is likely to stabilize. Inflation may mask the increasing liability, but examining the cost in real terms with no inflation shows that the early years of the residential operations are more profitable not counting resale income. From the first stabilized year to Year 12, residential operations cash flow with resident financing deteriorates 54%. The decline is due entirely to the nursing subsidy. Inflation mitigates the decline (5% income and expense inflation reduces the cash flow drop to 35%).

There is a way to lesson the risk of increasing and potentially volatile liability, aside from limiting nursing care. The alternative to self-insurance would be long-term care insurance. If obtained at the rate of an upfront payment by the developer of \$5,000 per unit and ongoing payments of \$100 per month per unit, it is more costly than self insurance at the calculated rate:

TABLE 5-8: COSTS OF SELF VS LONG-TERM CARE INSURANCE (12 YEARS)

	<u>Self- Insurance</u>	<u>Long-term Care Insurance</u>
Upfront Cost	\$0	\$1,500,000
PV Costs Years 1-12 @ 10%*	<u>\$3,278,066</u>	<u>\$2,698,222</u>
Total	\$3,278,066	\$4,198,222

*Present value figured for construction year

At the moment, the developers of Ashford have not found insurance rates this low, which is the rate they anticipated. Furthermore the insurance has a deductible that the facility would have to pay for. It would cost at least \$900,000 more than self insurance at the projected utilization, although it becomes incrementally cheaper over the longer term if annual premiums continue to cost less than the annual subsidy.

Whether this is a justified expense in the short term (12 years) is indicated by analyzing the present value of different rates of permanent-patient nursing utilization. *At the same rate of year-to-year increase in utilization* , a worst-

case scenario of 30% more permanent utilization still costs less than the insurance premium. Cash flow of residential operations in Year 12 can still absorb the subsidy. However, if the utilization rate begins higher or rises faster; if nursing expense inflation outpaces revenue inflation, as it has in the past; or if the facility runs into other problems that drain cash flow; then the insurance premium is considerably cheaper than worst-case scenarios. Since both the subsidy amounts and the insurance costs are uncertain at this point, recommendations on how to pay for the subsidy will have to depend on better data, preferably data with an actuarial basis.

If the opportunity to price some nursing care on a fee-for-service basis existed for Ashford, the savings would be considerable. If developers guaranteed nursing care to the relatively stable temporary patients only, the savings could be passed on to residents and lessen the chances that the community would default on this obligation. The present value of the permanent usage alone is \$1,696,066. This is a trend among "second-wave" and "third-wave" CCRC's. Yet the all-inclusive continuing care program is a highly marketable product because it gives seniors the most freedom from worry about their own financial status. Proper analysis of the liability should allow a solvent structure to be applied. While guaranteeing nursing care incurs risk, the risk appears manageable in well-capitalized projects.

Within a project, one alternative to funding all of the subsidy out of residential operating revenues is to assign all resale revenues to help defray the subsidy or build a reserve whose income funds the subsidy. These two income streams are well matched in some ways: resale income should increase as the subsidy does. Revenues from resales are a potential source of funding for the nursing liability with price appreciation; without it, the revenues are not sufficient. With an appreciation rate equal to or greater than the nursing inflation rate, the revenues *eventually* rise high enough to cover the nursing subsidy. The respective rates determine when the revenues are sufficient. Counting on such appreciation is a risky way to the nursing liability.

The relative importance of a particular profit center in a CCRC varies with financing, pricing, size of the component, and "policy" decisions on the part of the developer. For Ashford, consolidated statements of all the profit centers with various financing alternatives are presented in Chapter 6. In general, however, the various profit centers have some risk attributes across different financing schemes:

TABLE 5-9: MAJOR PROFIT CENTER RISKS

<u>Profit Center</u>	<u>Major Risks</u>
Startup Revenues	Pricing at too low a margin Slow absorption High construction costs Depletion by reserve funding
Residential Operations	Slow occupancy Excess expense inflation over income inflation Inability to pass through price increases (Nursing--see below)
Resale Activity	Depreciation of unit prices Slow resale of vacated units High turnover in combination with above
Nursing Operations	High nursing utilization Maintaining empty beds for resident use Excess expense inflation over income inflation

The role of financing is to mitigate these risks and, of course, maximize returns. Chapter 6 discusses financing mechanisms with these considerations in mind.

Financing "Ashford": Debt or No Debt

This chapter focuses on long-term financing of Ashford. It discusses the returns, risks and advantages of the two fee structure and financing combinations under consideration for Ashford, both of which require upfront fees. The developers of Ashford are seriously considering schemes:

- *Resident financing*, using the unit sales revenue as a permanent take out of the construction loan.
- *Permanent mortgage financing with a trust*, where some or all of the sales revenue is invested in a trust whose income funds the debt service

This chapter will discuss these as well as a third plan not under consideration:

- *An all-rental fee structure*, with no upfront fees, also using mortgage financing

The analysis shows that for the proprietary developer, in a project with Ashford's characteristics, resident financing is likely to offer the greatest and least risky financial returns. Mortgage financing with a trust carries arbitrage problems which the financing structure must overcome as well as various other drawbacks. Mortgage financing with an all-rental fee structure can potentially produce very large returns for the developer, but the risk that they will not materialize is considerable.

Ashford is an upscale CCRC. Its price levels with the two upfront fee alternatives result in a large initial "building profit"---the retail price in excess of cost---most of which may be returned to the developer immediately depending on the fee structure. This is a distinguishing characteristic of proprietary CCRC's over the most non-profit projects, which usually price

upfront fees at or below building cost.¹ Obviously this startup profit enriches the developer. Can other financing methods offer alternative sources of profit that return as much? How does the return of building profit to the developer affect the solvency of the project?

1. RESIDENT FINANCING

The distinguishing feature of using upfront payments as a permanent take-out, as noted, is that a large profit is made immediately. The size of this profit depends on the size of the reserve established, but it is large enough in Ashford's case to allow both a significant startup return and a large reserve. While the sections above have presented parts of the resident financing alternative, TABLE 6-1 is a consolidated statement giving summary data.

The consolidated statement shows that almost two thirds of the return in present value terms comes from the startup profit. Nursing center return is rendered almost insignificant (3.3%) and resale income is minor (12.8%). A nearly 200% total return on equity in present value terms (profitability index) illustrates the profitability of the project over twelve years (plus two years startup and initial construction). Even considering the risk incurred, the returns of this scheme appear excellent.

Reserves. The handling of the startup profit offers a number of different opportunities for dealing with the special risks and liabilities of a CCRC. These calculations assume a \$1 million general reserve, which can be used for nursing subsidies, refunds, and other expenditures if other revenue sources are insufficient. As the sections on nursing subsidies and resales in Chapter 5 suggest, this amount may be too little to cover the multi-million dollar liabilities. Furthermore, non-profit CCRC's which do make building profits usually return most of them to the reserve. Their competition may require a bigger reserve. TABLE 6-2 (page 70) shows the effect of increasing the reserve.

¹Laventhol and Horwath, p. 16, cites median entrance fees of \$38,000-\$96,000 for studio to three-bedroom units in post-1977 projects. Nearly all of sample is non-profits.

TABLE 6-1: RESIDENT FINANCING---CONSOLIDATED STATEMENT (in 000's)

ACTIVITY: YEAR:	START UP	CONST/OPER	OPER 1	OPER 2	OPER 3	OPER 4	OPER 5	OPER 6	OPER 7	OPER 8	OPER 9	OPER 10	OPER 11	OPER 12
<i>RESIDENTIAL OPERATIONS:</i>														
1 TOTAL REVENUES			1,323	3,418	4,270	4,270	4,270	4,270	4,270	4,270	4,270	4,270	4,270	4,270
2 TOTAL OPERATING EXPENSES			(2,082)	(3,313)	(3,602)	(3,642)	(3,681)	(3,721)	(3,761)	(3,801)	(3,840)	(3,880)	(3,920)	(3,960)
3 NET OPERATING INCOME			(759)	105	668	628	588	548	509	469	429	389	349	310
4 TOTAL DEBT SERVICE/PARTICIPATION			0	0	0	0	0	0	0	0	0	0	0	0
5 BEFORE TAX CASH FLOW	0	0	(759)	105	668	628	588	548	509	469	429	389	349	310
	NPV	1,850												
<i>UNIT RESALES:</i>														
6 TURNOVER VALUE	1		0	458	917	1,375	1,833	2,291	2,750	3,208	3,666	3,666	3,666	3,666
7 RESALE INCOME	1	0	0	46	92	137	183	229	275	321	367	367	367	367
	NPV	1,161												
<i>NURSING CENTER:</i>														
8 TOTAL EFFECTIVE REVENUES			1,163	1,473	1,473	1,473	1,473	1,473	1,473	1,473	1,473	1,473	1,473	1,473
9 TOTAL OPERATING EXPENSES			(978)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)
10 NET OPERATING INCOME			185	322	322	322	322	322	322	322	322	322	322	322
11 DEBT SERVICE			(256)	(256)	(256)	(256)	(256)	(256)	(256)	(256)	(256)	(256)	(256)	(256)
12 BEFORE TAX CASH FLOW	0	0	(71)	67	67	67	67	67	67	67	67	67	67	67
	NPV	301												
<i>TOTAL:</i>														
13 START UP	(4,050)	0	0	13,096										
14 RESIDENTIAL OPER			(759)	105	668	628	588	548	509	469	429	389	349	310
15 UNIT RESALES			0	46	92	137	183	229	275	321	367	367	367	367
16 NURSING HOME			(71)	67	67	67	67	67	67	67	67	67	67	67
17 TOTAL CASH FLOW	(4,050)	0	(830)	13,314	826	832	838	844	850	856	862	823	783	743
		NPV % TOTAL												
START UP		5,789	63.6%											
RESIDENTIAL OPER		1,850	20.3%											
UNIT RESALES		1,161	12.8%											
NURSING CENTER		301	3.3%											
TOTAL		9,101	100.0%											
PROFITABIL.IND		192.2%												
IRR		50.0%												
EQUITY REQUIRED	(4,880)													
CASH ON CASH	overall a	40.2%		272.9%	16.9%	17.1%	17.2%	17.3%	17.4%	17.6%	17.7%	16.9%	16.0%	15.2%
	stabilize	16.9%												

NOTES:

All NPV's @ discount 10.0%

All NPV's figured for start up year---two years before Year 1

2 Includes replacement reserve

TABLE 6-2: RESIDENT FINANCING---EFFECT OF INCREASING THE RESERVE ON REVENUES* (000's)

<u>Reserve Amount</u>	<u>Startup NPV</u>	<u>% Total</u>	<u>Total NPV</u>	<u>% Change</u>
1,000	5,789	63.6%	9,101	0%
2,000	5,038	57.8%	8,719	-4.2%
3,000	4,287	51.4%	8,337	-8.4%
4,000	3,535	44.4%	7,955	-12.6%
5,000	2,784	36.8%	7,573	-16.8%
6,000	2,033	28.3%	7,191	-21.0%
7,000	1,282	18.8%	6,809	-25.2%
8,000	530	8.3%	6,420	-29.4%
9,000	(221)	-3.7%	6,047	-33.6%
10,000	(972)	-17.2%	5,663	-37.8%

*NPV's discounted at 10%

A reserve of over \$8 million is possible before the startup profit is used *on a present value basis*. The developer can mitigate future risk by foregoing initial profit. The figure actually chosen should depend on actuarial analysis. Increasing the reserve itself raises financial structuring issues, because larger reserves increase interest income as long as the principal is not spent. Three alternatives for treating interest are:

1. If interest on the reserve accrues back to the developer through residential operations, and the reserve is not spent, the reserve functions as an annuity for the developer (albeit one subject to depletion of the reserve principal). This is why total NPV in TABLE 6-2 does not decline commensurately with the reserve increase. (One strategy to financially justify increasing the reserve is to give it a preferred return out of cash flow above prevailing interest rates.)
2. If the developer forsakes the interest income and it accrues back to the reserve, the reserve should grow as nursing and resale liabilities increase to further reduce risk. This strategy also makes a smaller initial reserve feasible.
3. It is possible use a large reserve to subsidize *residential* operations through lowering monthly fees with interest income. Again, where competition with non-profits affects pricing considerations, this should improve marketability.

**TABLE 6-3: RESIDENT FINANCING---
EQUITY REQUIREMENTS (in 000's)**

1	TOTAL SALES	45,825			
2	TOTAL DEVELOPMENT COSTS	<u>(38,015)</u>			
3	GROSS BUILDING PROFIT	7,810	17.0%		
4	LESS RESERVE	(1,000)			
5	NET BUILDING PROFIT	6,810			
	ACTIVITY:			CONST	
	YEAR:			OPER	
				1	2
6	START UP FUND	(375)			
7	LAND	(1,600)			
8	PRECONSTRUCTION COSTS	(1,700)			
9	MARKETING	(375)	(375)	(375)	(375)
10	REMAINING DEVELOPMENT COSTS	<u>(4,050)</u>	(16,420)	(16,420)	
11	RESERVE		(16,795)	(16,795)	(375)
12	SALES			22,913	22,913
13	SURPLUS (DEFICIT)	<u>(4,050)</u>	(16,795)	6,117	21,538
14	CONST FINANCING RECIEVED	0	16,795		
	CONST FINANCING PAID:				
15	WITH SURPLUS			(6,117)	(8,441)
16	WITH PERMANENT FINANCING			(2,237)	
20	DEVELOPMENT CASH FLOW	(4,050)	0	0	13,096
21	OPERATIONS CASH FLOW			(830)	218
22	EQUITY REQUIRED	<u>(4,050)</u>	0	(830)	13,314
23	CUMMULATIVE	(4,050)	(4,050)	(4,880)	8,435
	CONST FINANCING OUTSTANDING		(16,795)	(8,441)	0
	PERMANENT FINANCING RECEIVED			2,237	
	PERMANENT FINANCING OUTSTANDING			(2,237)	(2,237)

NOTES:

- 2 Does not include operating deficit
- 10 Total development costs less all costs in lines 6-9
- 14 Assumes full coverage
- 21 From TABLE 9

Whichever strategy is used, it is apparent that the ability to establish a large reserve and the benefits of reserve income are strong advantages of resident financing.

Equity Requirements. Preconstruction expenses total \$4,050,000 in all the financing schemes. This, combined with losses in the first year of operation, results in total project equity of \$4,880,000. TABLE 6-3 shows cash flow during the initial four years, and how equity is quickly returned through startup profits.

The developers of Ashford plan to finance some of the preconstruction costs. While normally construction financing would require 50% presales to start, the developers expect to receive more lenient treatment. This financing will further enhance the returns, but it should do so equally in all financing alternatives.

Syndication of the startup equity would also enhance the developers' returns. Its effect on returns would depend on how investors' return of equity is timed. If paid out of operations cash flow or resale income and not startup profit, syndication would relatively improve the standing of the resident financed alternative to the others. Any reduction of the startup profit erodes the primary advantage of resident financing.

Inflation. The large startup profit of resident financing makes project overall return less sensitive to inflation than other financing. Furthermore, there is no opportunity to benefit from an increasing spread between partially fixed expenses which exists with fixed debt service, and inflation-driven income. The effect of inflation on the net present value of the consolidated returns, when income and expense inflation are the same, is as follows:

TABLE 6-4: RESIDENT FINANCING---EFFECT OF INFLATION ON TOTAL REVENUE (PRICE INFLATION 0%)

<u>Income and Expense</u>	<u>Total NPV*</u>	<u>% Change</u>
0%	\$9,101,000	0.0%
2%	\$9,637,000	5.9%
4%	\$10,246,000	12.5%
6%	\$10,936,000	20.2%
8%	\$11,719,000	28.8%

*Discounted at 10%

The relatively small effect on total return when income and expense inflation increase concomitantly should not obscure the threat to cash flow if negative inflation *spreads* emerge. A spread of just one percent of more expense inflation than income inflation results in negative residential operations NOI by Year 11 or 12 depending on the respective inflation rates. By Year 12, NOI is less than a tenth of revenues; there is little tolerance for the downside risk of inflation unless prefunding of the nursing liability is made.

In sum, the resident financing alternative offers considerable startup profits, ample reserve funding and possibly advantageous use of syndication. These are benefits to the developer. What price is paid? For the developer, the project does not respond to the upside potential of inflation. For residents, only the underlying real estate provides financial security beyond the reserve. Because permanent debt does not encumber the property, there is no threat of foreclosure. The community could fail and have to dissolve, however, after unanticipated occupancy and resale problems, nursing liability, or inflation spreads. Then the somewhat illiquid and specialized physical plant is the only security to pay off refunds. Mortgage financing is one method to address this problem.

2. MORTGAGE FINANCING WITH A TRUST

The traditional way to finance CCRC's, before developers began to use upfront fees as permanent take-outs, has been to invest the sale proceeds in an investment trust which funds debt service on a tax-exempt bond. If the financing is secured by the real estate, the trust constitutes a source of refunds

in case of project failure. Furthermore, where financing permits positive arbitrage, the trust is leveraged to increase revenues for the facility. The benefits of mortgage financing diminish considerably when positive arbitrage is not available. Does it still make sense? Compared to resident, financing, the answer is a qualified no.

Mortgage financing with an upfront fee structure involves five key issues:

1. *Arbitrage* ---the rate differential between investment interest and mortgage interest---can make or break mortgage financing.
2. *Amortization* on the mortgage, if any, can intensify the effect of negative arbitrage by effectively increasing the loan's nominal interest rate.
3. *Initial funding*, such as a short-term reserve and return of equity, can diminish funds available for the trust and thus debt ratio.
4. The *term* of the mortgage raises issues of refinancing security.
5. *Liquidity* of the trust, if it is invested in long-term instruments to yield high rates, may be incompatible with cash needs in worst case scenarios.

Arbitrage and Amortization. Positive arbitrage is often possible with tax-exempt financing, and it allows non-profits to finance 100% of costs, including the high fees involved, with entrance prices that may total less than the mortgage issue. Tax-exempt financing is not a workable option at Ashford, nor at many other proprietary, upfront-fee projects for reasons such as inclusionary unit requirements, high fees, and possibly unfavorable tax treatment of positive arbitrage. At best, Ashford can realize neutral or negative arbitrage; the latter is more likely.

TABLE 6-5 shows maximum debt with various arbitrage spreads between interest income and nominal mortgage interest. Debt in each of the cases is set by the maximum amount the trust could fund after paying for reserves, development deficits and interest on the developer's equity (explained in the Equity Return and Reserve Funding section below). This assumes 100% sell out, and use of 100% of the interest income for debt service. Obviously, prudent debt levels would be even lower to account for shortfalls in initial sales and variability in interest income.

TABLE 6-5: EFFECT OF ARBITRAGE ON MAXIMUM DEBT AMOUNT

1	2	3	4	5	6	7	8	9
INCOME MORTGAGE INTEREST	MORTGAGE INTEREST	SPREAD	TOTAL SALES	DEVELOPMENT COST	NET SALES TO TRUST	TRUST INCOME & DEBT SER	DEBT	LTV RATIO
8.0%	8.0%	0.0%	45,825,000	39,866,653	64,027,029	5,122,162	58,172,181	126.9%
8.0%	8.5%	-0.5%	45,825,000	39,339,570	47,993,202	3,839,456	41,611,272	90.8%
8.0%	9.0%	-1.0%	45,825,000	39,042,462	38,955,226	3,116,418	32,276,188	70.4%
8.0%	9.5%	-1.5%	45,825,000	38,851,991	33,161,130	2,652,890	26,291,621	57.4%
8.0%	10.0%	-2.0%	45,825,000	38,719,628	29,134,665	2,330,773	22,132,793	48.3%
8.0%	10.5%	-2.5%	45,825,000	38,622,403	26,177,103	2,094,168	19,078,007	41.6%
8.0%	11.0%	-3.0%	45,825,000	38,548,038	23,914,914	1,913,193	16,741,451	36.5%
ASSUMPTIONS:		RESERVE			1,000,000			
		EQUITY INTEREST PAYMENT			1,340,000			
		ORIGINATION FEES			3.0%			
		NURSING CENTER MORTGAGE			2,236,500			

2 Face rate, not constant

5 Does not include reserve or interest on equity

6 Remainder of sales spent on development cost deficit, reserve, and interest on equity

7 100% of trust income goes to debt service

9 Ratio of debt amount to total sales. Does not include nursing center debt.

Negative arbitrage more than one percentage point results in very low loan-to-value ratios. With a spread of zero points, a maximum theoretical mortgage could far exceed the development cost, and augment the trust to a level above the sales price. With positive arbitrage, there is virtually no limit to maximum theoretical debt, although underwriting and regulatory standards, of course, would limit debt. With non-amortizing loans, the debt amount can be considerably higher: about 40% higher with neutral arbitrage, and 23% higher with 2% negative arbitrage. Different interest rates also have an effect. If the spread is based on an interest income rate of less than 8%, the spread is proportionately more significant and the loan-to-value ratio declines. A higher income interest rate, conversely, improves the ratio.

The actual spread that can be expected at Ashford will depend on debt sources, and the trust and debt source are likely to be tied together. Two cases are examined: an ideal spread of zero points, with debt of \$36,660,000 (80% loan-to-value ratio); and a spread of two points, with debt of \$22,132,793. The debt depends on full sell out. (More detailed parts of the proformas are APPENDIX TABLES 4-9.) Consolidated statements are in TABLES 6-6 and 6-7. (In both cases construction financing costs are assumed to be equal with the resident financed alternative, because the permanent loan could be phased in, or the sales revenue could take out the construction loan until replenished by the permanent mortgage.)

Neither alternative requires a net equity investment after sell-out. On the whole, however, returns are close to the non-startup returns of the resident-financed alternative, although returns from residential operations are marginally higher than with resident financing because interest is earned during Year 2. In addition, the return with neutral interest-rate arbitrage is greater because the trust earns excess income over debt service. In the proforma this accrues to the developer, but as with resident financing there are many ways to treat this investment income (see Section 1---Reserves).

These trust/mortgage financing alternatives benefit slightly more from inflation than resident financing, because inflation-insensitive startup profits are not a part of the returns. With 8% income and expense inflation, for

TABLE 6-6: TRUST/MORTGAGE FINANCING WITH 0% ARBITRAGE---CONSOLIDATED STATEMENT (in 000's)

ACTIVITY:	START UP	CONST/OPER	OPER	OPER	OPER	OPER	OPER	OPER	OPER	OPER	OPER	OPER	OPER																																																																																																																																																										
YEAR:		1	2	3	4	5	6	7	8	9	10	11	12																																																																																																																																																										
<i>RESIDENTIAL OPERATIONS:</i>																																																																																																																																																																							
1	TOTAL REVENUES		1,323	3,941	7,725	7,725	7,725	7,725	7,725	7,725	7,725	7,725	7,725																																																																																																																																																										
2	TOTAL OPERATING EXPENSES		(2,082)	(3,313)	(3,602)	(3,642)	(3,681)	(3,721)	(3,761)	(3,801)	(3,840)	(3,880)	(3,920)																																																																																																																																																										
3	NET OPERATING INCOME		(759)	628	4,124	4,084	4,044	4,004	3,965	3,925	3,885	3,845	3,805																																																																																																																																																										
4	TOTAL DEBT SERVICE/PARTICIPATION		0	0	(3,228)	(3,228)	(3,228)	(3,228)	(3,228)	(3,228)	(3,228)	(3,228)	(3,228)																																																																																																																																																										
5	BEFORE TAX CASH FLOW	0	(759)	628	896	856	816	776	737	697	657	617	577																																																																																																																																																										
	NPV	3,296																																																																																																																																																																					
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6	TURNOVER VALUE	1	0	458	917	1,375	1,833	2,291	2,750	3,208	3,666	3,666	3,666																																																																																																																																																										
7	RESALE INCOME	1	0	46	92	137	183	229	275	321	367	367	367																																																																																																																																																										
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8	TOTAL EFFECTIVE REVENUES		1,163	1,473	1,473	1,473	1,473	1,473	1,473	1,473	1,473	1,473	1,473																																																																																																																																																										
9	TOTAL OPERATING EXPENSES		(978)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)																																																																																																																																																										
10	NET OPERATING INCOME		185	322	322	322	322	322	322	322	322	322	322																																																																																																																																																										
11	DEBT SERVICE		(256)	(256)	(256)	(256)	(256)	(256)	(256)	(256)	(256)	(256)	(256)																																																																																																																																																										
12	BEFORE TAX CASH FLOW	0	(71)	67	67	67	67	67	67	67	67	67	67																																																																																																																																																										
	NPV	301																																																																																																																																																																					
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13	START UP	(4,050)	0	5,390																																																																																																																																																																			
14	RESIDENTIAL OPER		(759)	628	896	856	816	776	737	697	657	617	577																																																																																																																																																										
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16	NURSING HOME		(71)	67	67	67	67	67	67	67	67	67	67																																																																																																																																																										
17	TOTAL CASH FLOW	(4,050)	0	(830)	6,131	1,054	1,060	1,066	1,072	1,078	1,084	1,090	1,051																																																																																																																																																										
													971																																																																																																																																																										
<table border="1"> <thead> <tr> <th></th> <th>NPV</th> <th>% TOTAL</th> <th colspan="11"></th> </tr> </thead> <tbody> <tr> <td>START UP</td> <td>0</td> <td>0.0%</td> <td colspan="11"></td> </tr> <tr> <td>RESIDENTIAL OPER</td> <td>3,296</td> <td>69.3%</td> <td colspan="11"></td> </tr> <tr> <td>UNIT RESALES</td> <td>1,161</td> <td>24.4%</td> <td colspan="11"></td> </tr> <tr> <td>NURSING HOME</td> <td>301</td> <td>6.3%</td> <td colspan="11"></td> </tr> <tr> <td>TOTAL</td> <td>4,756</td> <td>100.0%</td> <td colspan="11"></td> </tr> <tr> <td>PROFITABIL.IND</td> <td>100.4%</td> <td colspan="12"></td> </tr> <tr> <td>IRR</td> <td>27.5%</td> <td colspan="12"></td> </tr> <tr> <td>EQUITY REQUIRED</td> <td>(4,880)</td> <td colspan="12"></td> </tr> <tr> <td>CASH ON CASH</td> <td>overall a</td> <td>31.1%</td> <td>125.6%</td> <td>21.6%</td> <td>21.7%</td> <td>21.9%</td> <td>22.0%</td> <td>22.1%</td> <td>22.2%</td> <td>22.3%</td> <td>21.5%</td> <td>20.7%</td> <td>19.9%</td> </tr> <tr> <td></td> <td>stabilizer</td> <td>21.6%</td> <td colspan="11"></td> </tr> </tbody> </table>															NPV	% TOTAL												START UP	0	0.0%												RESIDENTIAL OPER	3,296	69.3%												UNIT RESALES	1,161	24.4%												NURSING HOME	301	6.3%												TOTAL	4,756	100.0%												PROFITABIL.IND	100.4%													IRR	27.5%													EQUITY REQUIRED	(4,880)													CASH ON CASH	overall a	31.1%	125.6%	21.6%	21.7%	21.9%	22.0%	22.1%	22.2%	22.3%	21.5%	20.7%	19.9%		stabilizer	21.6%											
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NOTES:

All NPV's @ discount 10.0%

All NPV's figured for start up year---two years before Year 1

2 Includes replacement reserve

TABLE 6-7: TRUST/MORTGAGE FINANCING WITH 2% ARBITRAGE---CONSOLIDATED STATEMENT (in 000's)

ACTIVITY:	START UP	CONST	ST/OPER	OPER	OPER	OPER	OPER	OPER	OPER	OPER	OPER	OPER	OPER	OPER
YEAR:			1	2	3	4	5	6	7	8	9	10	11	12
<i>RESIDENTIAL OPERATIONS:</i>														
1	TOTAL REVENUES		1,323	3,978	6,600	6,600	6,600	6,600	6,600	6,600	6,600	6,600	6,600	6,600
2	TOTAL OPERATING EXPENSES		(2,082)	(3,313)	(3,602)	(3,642)	(3,681)	(3,721)	(3,761)	(3,801)	(3,840)	(3,880)	(3,920)	(3,960)
3	NET OPERATING INCOME		(759)	665	2,998	2,959	2,919	2,879	2,839	2,800	2,760	2,720	2,680	2,640
4	TOTAL DEBT SERVICE/PARTICIPATION		0	0	(2,331)	(2,331)	(2,331)	(2,331)	(2,331)	(2,331)	(2,331)	(2,331)	(2,331)	(2,331)
5	BEFORE TAX CASH FLOW	0	0	(759)	665	668	628	588	548	509	469	429	389	349
	NPV	2,271												
<i>UNIT RESALES:</i>														
6	TURNOVER VALUE	1	0	458	917	1,375	1,833	2,291	2,750	3,208	3,666	3,666	3,666	3,666
7	RESALE INCOME	1	0	0	46	92	137	183	229	275	321	367	367	367
	NPV	1,161												
<i>NURSING CENTER:</i>														
8	TOTAL EFFECTIVE REVENUES		1,163	1,473	1,473	1,473	1,473	1,473	1,473	1,473	1,473	1,473	1,473	1,473
9	TOTAL OPERATING EXPENSES		(978)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)
10	NET OPERATING INCOME		185	322	322	322	322	322	322	322	322	322	322	322
11	DEBT SERVICE		(256)	(256)	(256)	(256)	(256)	(256)	(256)	(256)	(256)	(256)	(256)	(256)
12	BEFORE TAX CASH FLOW	0	0	(71)	67	67	67	67	67	67	67	67	67	67
	NPV	301												
<i>TOTAL:</i>														
13	START UP	(4,050)	0	0	5,390									
14	RESIDENTIAL OPER		(759)	665	668	628	588	548	509	469	429	389	349	310
15	UNIT RESALES		0	46	92	137	183	229	275	321	367	367	367	367
16	NURSING HOME		(71)	67	67	67	67	67	67	67	67	67	67	67
17	TOTAL CASH FLOW	(4,050)	0	(830)	6,168	826	832	838	844	850	856	862	823	743
	NPV % TOTAL													
	START UP	0	0.0%											
	RESIDENTIAL OPER	2,271	60.9%											
	UNIT RESALES	1,161	31.1%											
	NURSING HOME	301	8.1%											
	TOTAL	3,732	100.0%											
	PROFITABIL.IND	78.8%												
	IRR	25.0%												
	EQUITY REQUIRED	(4,880)												
	CASH ON CASH	overall av	26.9%		126.4%	16.9%	17.1%	17.2%	17.3%	17.4%	17.6%	17.7%	16.9%	16.0%
		stabilized	16.9%											15.2%

NOTES:

- 1 All NPV's @ discount 10.0%
- 2 All NPV's figured for start up year---two years before Year 1
- 2 Includes replacement reserve

example, the neutral-arbitrage alternative's total NPV increases 55%, and the negative-arbitrage scheme's return increases 70%. These compare with 28% for resident financing. Although fixed debt is involved with these alternatives, it is funded separately by the trust and does not play a role in leveraging inflation to increase benefits as it does with the rental scheme.

Equity Return and Refund Funding. With trust/mortgage financing, it is difficult to fund initial outlays beyond the facility cost. These outlays include startup profits and reserves. The degree of difficulty depends on whether the outlay can be funded by the debt as a development cost. With resident financing, it is easy to fund large reserves and to return equity early in the project's life. The trust/mortgage financing alternatives assume a return of the equity as well as interest on it. This results in a startup NPV of \$0. But to yield a startup *profit* or to fund a reserve larger than \$1 million may reduce the debt amount drastically, reverting the project to primarily resident financing. With a total of \$4 million startup payment (for either use), the maximum possible debt for three arbitrage spreads decreases as follows:

TABLE 6-8: EFFECT OF INCREASING THE RESERVE ON MAXIMUM DEBT

<u>Interest Spread</u>	<u>Debt With \$1m Startup</u>	<u>Debt With \$4m Startup</u>
0.0%	\$58,172,181	\$35,526,195
1.0%	\$32,276,188	\$19,711,318
2.0%	\$22,132,793	\$13,516,668

*Income interest rate 8%

These are the debt amounts that result when the increased upfront costs *are not funded by the debt*. They show that to increase initial funding significantly appears worthwhile with only neutral arbitrage or negligible positive arbitrage. If these expenses can be included in the debt coverage, however, funding becomes somewhat easier. For example, for a \$36,660,000 loan with neutral arbitrage, fees or reserves of up to 10.25% of the debt are possible until trust interest cannot cover debt service. But with significant negative arbitrage, such amounts of upfront fees quickly become impossible without drastically reducing debt amounts. Furthermore,

proprietary developers will find it hard to secure debt that will fund startup profits *per se*.

Term. The term of the mortgage is one issue that further differentiates proprietary developers from non-profits. Whereas non-profits can frequently obtain long-term bond financing, proprietary developers seeking conventional loans are confronted with short terms and consequent financing risk. One bank informally quoted a term of five years to the Ashford developers, which would compel the developer to refinance or extend the loan at that time. Banks appear hesitant to commit themselves to long-term lending on a type of product that is so untested. When the loan matures, higher rates could threaten the project, since the investments are likely to be in long-term instruments and not easily reinvested. The term of the loan should be tied to the investment term of the trust. A refinancing profit is possible if the trust has been augmented with resale revenues, but the same level of debt after refinancing is more likely.

Liquidity. A major purpose of the trust is to have cash funds available for refund in case the project defaults and the lender forecloses. If tied up in long-term investments, as with refinancing, the trust is somewhat less liquid. If the yield is competitive with current rates, the investments could be liquidated relatively fast at a discount off their face value. Since a maximum of 90% will normally be refundable, and less in inflationary times, substantial leeway should exist for adequate refunds after selling the investments at a discount. A greater problem may be that with much positive arbitrage, the net trust value is lower along with the debt amount. It is unlikely to cover much of the refund liability if the project defaults, even if supplemented with other revenues such as resale proceeds. The value provided to the residents by the trust in a foreclosure may be as little as the realizable value of the facility in the failure of a resident-financed project. A key reason for choosing the trust/mortgage financing alternative in the first place is resident security, and arbitrage nullifies the effect.

In sum, mortgage financing with a trust for resident security appears to be desirable with neutral (or positive) arbitrage. As a proprietary project, Ashford is likely to use conventional mortgage financing and thus have

negative arbitrage, and even with inflation the returns to the developer are low. The problems of term and trust liquidity pose some risk. Upfront funding of reserves (or startup profit) is difficult with negative arbitrage. Most of all, however, the drawback is the very low loan-to-value ratio, and a trust of limited value to residents.

3. AN ALL-RENTAL FEE STRUCTURE WITH MORTGAGE FINANCING

The all-rental fee structure is the norm in congregates but rare in continuing care centers. The rental structure, as discussed in Chapter 4, offers advantages such as exemption from some state regulations affecting upfront fee projects, presumed easier marketability, and no future refund liability. But its financial drawbacks in a CCRC are enormous, although not insurmountable. These include:

- Necessarily high rents which make qualifying incomes very high.
- The lack of Federal and a dearth of private credit enhancement to secure low mortgage rates.
- The difficulty in most cases of pulling equity out of the project in the early years.
- The difficulty of establishing large reserves for nursing care liability.

In addition to the absence of refund liability, the rental structure also has three other financial attractions which partly balance these drawbacks:

- With fixed debt, much greater sensitivity to inflation which can result in huge cash flow increases in the right circumstances.
- Potential profit from future sale of the facility.
- The tax advantage of depreciation that is not conferred on developers of cooperative projects.

This section will discuss these issues in the context of Ashford.

The amount of debt a proprietary CCRC can secure from conventional sources is subject to high coverage requirements. Ratios of 1.20 to 1.25 are

probably required. For a base case at Ashford, a 10%, 30-year amortizing mortgage of \$36,660,000 (80% of the sales value) has been used for comparability with one of the trust/mortgage financing loans. Rents have been increased from the level in the other alternatives to cover the debt service (with a vacancy factor). The loan is funded after the eighteen months of construction, and adjustments have been made to such factors as the replacement reserve and management fee. Debt coverage at stabilization is 1.18. TABLE 6-9 shows consolidated returns. (See APPENDIX TABLES 10-11 for remaining parts of the proforma.)

Rent Levels. At Ashford, the necessary rent levels create real and perceived affordability problems. The real affordability problem is that rents for Ashford would have to increase over \$1100 (from the rents in the first two alternatives) to cover the debt service, with allowance for vacancy. The average rent would be \$2258. The difference, if capitalized at an approximate investment income rate of 8%, is worth \$169,500. This is about \$17,000 more than the average price assumed in the upfront fee alternatives. Thus in this scenario the rental alternative is more expensive than buying for prospects. It always will cost more if negative arbitrage is at play between investment income rates for residents and mortgage rates for developers. Delivering lower rents would necessitate accepting lower operating cash flow than with the other alternatives; reducing expenses by changing the product configuration or service package; or securing lower cost debt.

The perceived affordability problem is that if prospects have yet to invest their home equity and realize its income potential, they may feel their purchasing power is inadequate. Even when the rental price is the same or better than buying, comparability may not be recognized. Monthly fees of over \$2000 rival even more service-intensive housing such as nursing homes. In Ashford's case residents would need incomes of \$45,160, qualifying at 60% of income, to pay the fees. These issues illustrate how rental structures in CCRC's raise practical affordability problems. Rental structures make more marketing sense where lower expenses and debt costs are possible, as with congregates or less luxurious CCRC's.

TABLE 6-9: ALL-RENTAL STRUCTURE---CONSOLIDATED STATEMENT (in 000's)

ACTIVITY: YEAR:	START UP	CONSTST/OPER	OPER	OPER	OPER	OPER	OPER	OPER	OPER	OPER	OPER	OPER	OPER
		1	2	3	4	5	6	7	8	9	10	11	12
<i>RESIDENTIAL OPERATIONS:</i>													
1	TOTAL REVENUES		2,583	6,650	8,134	8,134	8,134	8,134	8,134	8,134	8,134	8,134	8,134
2	TOTAL OPERATING EXPENSES		(1,925)	(3,273)	(3,605)	(3,645)	(3,685)	(3,724)	(3,764)	(3,804)	(3,844)	(3,884)	(3,923)
3	NET OPERATING INCOME		659	3,377	4,529	4,489	4,449	4,410	4,370	4,330	4,290	4,250	4,211
4	TOTAL DEBT SERVICE/PARTICIPATION		(1,930)	(3,861)	(3,861)	(3,861)	(3,861)	(3,861)	(3,861)	(3,861)	(3,861)	(3,861)	(3,861)
5	BEFORE TAX CASH FLOW	0	0	(1,272)	(483)	668	629	589	549	509	469	430	390
	NPV	987											
<i>UNIT RESALES:</i>													
6	TURNOVER VAL	1	0	0	0	0	0	0	0	0	0	0	0
7	RESALE INCOME	1	0	0	0	0	0	0	0	0	0	0	0
	NPV	0											
<i>NURSING CENTER:</i>													
8	TOTAL EFFECTIVE REVENUES		1,163	1,473	1,473	1,473	1,473	1,473	1,473	1,473	1,473	1,473	1,473
9	TOTAL OPERATING EXPENSES		(978)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)	(1,151)
10	NET OPERATING INCOME		185	322	322	322	322	322	322	322	322	322	322
11	DEBT SERVICE		(256)	(256)	(256)	(256)	(256)	(256)	(256)	(256)	(256)	(256)	(256)
12	BEFORE TAX CASH FLOW	0	0	(71)	67	67	67	67	67	67	67	67	67
	NPV	301											
<i>TOTAL:</i>													
13	START UP	(4,050)	0	2,734	(375)								
14	RESIDENTIAL OPER		(1,272)	(483)	668	629	589	549	509	469	430	390	350
15	UNIT RESALES		0	0	0	0	0	0	0	0	0	0	0
16	NURSING HOME		(71)	67	67	67	67	67	67	67	67	67	67
17	TOTAL CASH FLOW	(4,050)	0	1,392	(792)	735	695	656	616	576	536	497	457

	NPV	% TOTAL
START UP	(2,072)	264.2%
RESIDENTIAL OI	987	-125.9%
UNIT RESALES	0	0.0%
NURSING CENTI	301	-38.3%
TOTAL	(784)	100.0%
PROFITABIL.INI	-27.0%	
IRR	4.6%	
EQUITY REQUIR	(4,050)	
CASH ON CASH overall av	10.7%	
stabilized	13.7%	
		-19.5%
		18.2%
		17.2%
		16.2%
		15.2%
		14.2%
		13.2%
		12.3%
		11.3%
		10.3%
		9.3%

NOTES:

All NPV's @ discc 10.0%

All NPV's figured for start up year---two years before Year 1

2 Includes replacement reserve

Equity Return and Reserve Funding. Aside from futures, the returns realizable from a rental structure (See TABLE 6-9) are essentially just the income streams from residential operations and nursing. These are not high enough to cover the equity investment over the 12-year period at the rent and debt assumptions, and a negative present value is the result. Furthermore, it is likely that loan amounts would be based on cost and not the "value created," requiring even more equity and making high reserve funding more difficult. This suggests that rental structures are appropriate for using outside equity financing, and for limiting liabilities requiring high reserves. Limiting nursing care guarantees would allow a smaller reserve, provided a reserve is not required for debt service by regulation.

TABLE 6-10 shows that to increase returns significantly, without using equity financing or limiting nursing subsidies, through rents requires at least a 10% rise:

TABLE 6-10: RENTAL ALTERNATIVE---EFFECT OF RENT CHANGES (ALL INFLATION 0%; 000's except rent)

<u>Change in Rent</u>	<u>Gross Pot, Income YR1</u>	<u>DCR YR3</u>	<u>Average Rent</u>	<u>Total NPV*</u>	<u>Change NPV</u>
-20.0%	5,744	0.85	1,859	(7,702)	-882.1%
-15.0%	6,103	0.93	1,958	(5,973)	-661.6%
-10.0%	6,462	1.01	2,058	(4,243)	-441.0%
-5.0%	6,821	1.09	2,158	(2,514)	-220.5%
0.0%	7,180	1.17	2,258	(784)	0.0%
5.0%	7,539	1.25	2,357	945	220.5%
10.0%	7,898	1.34	2,457	2,675	441.0%
15.0%	8,257	1.42	2,557	4,404	661.6%
20.0%	8,616	1.50	2,656	6,134	882.1%

*Discounted at 10%

Securing a lower mortgage rate is relatively more ineffective than rent raises. It is necessary to lower the rate over 10% (one interest rate point) to realize the same return as raising the rent 5%.

Inflation. With no inflation, the returns from a rental structure compare unfavorably with the two for-sale structures. But the impact of inflation, if applied to the entire revenues and expenses, allows dramatic improvement in returns if the project is leveraged with fixed debt.

TABLE 6-11: RENTAL ALTERNATIVE---EFFECT OF INFLATION ON TOTAL REVENUE

<u>Income and Expense Inflation</u>	<u>Total NPV*</u>	<u>% Change</u>
0%	(\$784,000)	0.0%
2%	\$1,938,000	347.2%
4%	\$5,011,000	739.2%
6%	\$8,481,000	1181.7%
8%	\$12,402,000	1681.2%

*Discounted at 10%

This increase is contingent on raising the entire rent, including the portion used for debt service. Affordability obstacles (eg, the inability of residents to absorb full increases), or external measures such as rent control, might stall such large increases. If not, then the rental structure can equal the returns of the other alternatives with income and expense inflation of 6%-8%. However, if the *excess* proceeds from resales are counted as returns with the upfront fee alternatives, then inflation has to be higher.

With excess expense inflation over income inflation, the rental alternative can withstand a greater spread than the other alternatives, provided once again that the income inflation rate covers all revenues.

Futures and Tax Benefits. The missing component in the returns, of course, is residual value after a sale or refinancing. The role that futures will play in rental CCRC's is uncertain. If the value is based on capitalized operating income and if the nursing liability increases, then the facility's value may fall in real terms. Limiting, insuring, or prefunding with reserves the nursing liability may be necessary to prevent this, although with inflation it diminishes as a problem. Legal considerations may slightly hinder a sale; changing the the holder of the nursing center CON may be difficult, requiring the sale of the legal entity that owns the project. Likewise, state CCRC regulations may limit transfer of certification. Lenders, concerned about the management intensity of retirement centers, may have limitations on management changes. To quantify the potential futures, the following figures show the present value (for the preconstruction startup year) of a sale in Year 13. The sales price is based on a 10% capitalization rate of total project NOI, and increasing nursing subsidies:

TABLE 6-12: RENTAL ALTERNATIVE---RETURN FROM FUTURES*

	<u>0% Inflation</u>	<u>4% Inflation</u>	<u>8% Inflation</u>
Sales Price	\$44,930,000	\$69,120,000	\$104,920,000
Debt Repayment	<u>\$34,177,575</u>	<u>\$34,177,575</u>	<u>\$34,177,575</u>
Net proceeds	\$10,752,425	\$34,942,425	\$70,742,420
PV @ 10%	\$2,831,450	\$9,201,450	\$18,620,692

• *Sale at Year 13

While inflation makes the returns very large, these are conditional on increase on all the revenues. Another way to analyze this is to note that the returns are about two to three times the total returns from resales that the upfront-fee alternatives yield at the same inflation rates. For this type of product, it is highly risky for the developer (or financing sources) to depend on futures. A safer strategy is to count on only a partial refinancing. Tax treatment may enhance their value relative to other types of developer profit, if they are taxed as capital gains. Capital gains differentials, however, may not survive pending tax reform legislation, especially for individuals.

Tax benefits also increase the value of rental income as a whole. Since the developer still owns the property it is possible to depreciate. With straight line, 30 year depreciation (which is likely after tax reform), Ashford could shelter over \$1 million each year. This is more than the total cash flow. Passive losses are unlikely to emerge from the tax reform, but the project cash flow may be actively sheltered. After-tax cash flow may be worth at least 30% more to a corporation.

In sum, the rental alternative offers problems with affordability and reserve funding. Limiting the nursing liability is strongly recommended. With high inflation in the right circumstances, before-tax operating returns can approximate those of the upfront-fee alternatives with similar inflation. Tax benefits may shelter cash flow, and futures can potentially multiply the returns many times. Under these best-case scenarios, returns may exceed those of other alternatives. But many uncertainties about the role of futures in CCRC's, about the probability of inflation and the ability to raise total rents, make these scenarios a risky basis upon which to base financing. To be a more assured investment for the developer, rents need to be much more expensive in capitalized terms than other alternatives, or debt at below-

market rates. Given the probable difficulty of achieving high rents because of affordability concerns, the lower-cost debt appears a more plausible alternative. At any rate, the debt amount assumed here---based on value created---is likely to be optimistic. A lower debt amount requiring more equity is more likely, and would only diminish the returns more.

4. FINANCING CONCLUSIONS

The final financing decision for a CCRC, including Ashford's case, must be made after specific debt sources have quoted rates to the developer. It must also follow decisions on refunds and nursing care, since these will determine how large certain reserves need to be. Finally, the decision must depend on the strategy of the developer regarding timing, including whether the developer seeks short-term startup profits, near-term operating profits or long-term futures.

Some of the risks with CCRC's are unique to the housing type (notwithstanding congregates which come close to CCRC's). Primarily, these are the risks that future costs for refunds and nursing care will be unexpectedly high. Discretionary policy decisions will affect these risks, as will factors beyond the developer's control such as regulation and affordability of long-term care insurance. Good actuarial projections and high reserve funding both mitigate these two risks.

Other risks of CCRC's are more common to all real estate. These include unexpectedly slow occupancy at startup, excessive construction costs, high interest-rates, and market downturns that cause high vacancy during the operating life of a project. Construction costs may affect different financing schemes more or less equally, but slow occupancy, the effect of market downturns, and high interest rates obviously depend on pricing and what kind of debt a project has.

A summary of Ashford's returns is in TABLE 6-13.

On the whole, resident financing appears to go farthest in Ashford's case to mitigate most of these risks, and at the same time is most profitable to the

TABLE 6-13: SUMMARY OF RETURNS (000'S)

ALTERNATIVE	STARTUP	RES OPER	RESALE	URSING	TOTAL	PROFIT. INDEX	ROE	INFLATION	INFLATION	RESERVE	TAX
							STAB. + RETURN	- RISK	- RISK	FUNDING	TREATMENT
RESIDENT FINANCING	5,789	1,850	1,161	301	9,101	192.2%	16.9% LOW	HIGH	EASY	UNFAVORABLE	
<i>Percent of total</i>	<i>63.6%</i>	<i>20.3%</i>	<i>12.8%</i>	<i>3.3%</i>	<i>100.0%</i>						
TRUST/MORTGAGE FINANCING											
0% ARBITRAGE	0	3,296	1,161	301	4,756	100.4%	21.6% LOW	HIGH	DIFFICULT	NEUTRAL	
<i>Percent of total</i>	<i>0.0%</i>	<i>69.3%</i>	<i>24.4%</i>	<i>6.3%</i>	<i>100.0%</i>						
-2% ARBITRAGE	0	2,271	1,161	301	3,732	78.8%	16.9% LOW	HIGH			
<i>Percent of total</i>	<i>0.0%</i>	<i>60.9%</i>	<i>31.1%</i>	<i>8.1%</i>	<i>100.0%</i>						
RENTAL	(2,072)	987	0	301	(784)	-27.0%	13.7% HIGH	MODERATE	VERY	FAVORABLE	
<i>Percent of total</i>	<i>264.2%</i>	<i>-126.0%</i>	<i>0.0%</i>	<i>-38.3%</i>	<i>100.0%</i>				DIFFICULT		

developer. For projects with different configurations, and with more innovative financing mechanisms, one of the other two alternatives might be more appropriate. Chapter 7 discusses these issues in greater detail. For Ashford, however, resident financing can mitigate the refund and nursing liabilities most easily because it allows for establishment of higher reserves. An appropriate reserve at Ashford is probably closer to \$3 to \$4 million than \$1 million, based on Chapter 5's crude estimates of refund and nursing liabilities. The developers, in fact, are considering a reserve in this range. A large reserve helps with marketing as well as risk-reduction for liabilities, since prospect may compare reserve amounts with competitors. A non-profit, resident-financed CCRC near Ashford, of similar size, purchase prices and services, funded a \$10,000,000 reserve out of startup profits. The reserve income helps to lower monthly fees. With such competition, large reserves may be a marketing necessity. In this sense resident-financing helps reduce occupancy risk. It also helps reduce occupancy risk through pricing, to the extent that it (along with the trust/mortgage-financed scheme) is less expensive on a capitalized basis for residents. Interest-rate risk is reduced since the project carries no permanent debt.

Resident-financing's greatest ostensible drawback is the lack of readily available refunds in case of a mass exodus (eg, with the closing of the facility). Yet the trust used with mortgage financing does not readily resolve this problem. With any significant negative arbitrage, it is necessarily small. With most negative arbitrage spreads, it is likely that the value of the facility sold at a discount is greater than the value of the trust, and potentially low liquidity of the trust further reduces its usefulness. Funding "short-term" reserves is hard with trust/mortgage financing, and the short maturity of conventional mortgages introduces a refinancing risk. If neutral or almost-neutral arbitrage were available, the trust/mortgage financing option would be more plausible. For proprietary projects it is not readily available, and playing with amortization and changes in the rate levels (eg, a higher rate of interest income as the basis for the spread) does not sufficiently reduce negative arbitrage to a feasible spread.

Choosing the permanent financing structure also involves construction financing considerations. If construction financing is tied to presales, both of

the upfront-fee alternatives may be advantageous, since the deposits required with presales are somewhat stronger collateral than the smaller ones paid for rental preleases. The upfront-fee projects also reduce risk because, with slow absorption, construction financing may be taken out with sales revenue. With rentals construction or permanent financing must be carried regardless of fill-up. This is more problematic with the trust alternative than with resident financing, but it may be possible temporarily until later sales fund the trust.

To this point, this section has listed the downside risks of the financing options. What is the upside potential? Solely because of its startup profit, resident-financing offers significantly more return to the developer than the trust/mortgage financing alternative. The rental alternative potentially offers significant return from futures and from operations with high inflation. But affordability problems might limit the full benefits of inflation, since affordability could easily constrain raising *all* fees at the inflation rate. Resident financing does not benefit from inflation as much. Yet its startup profit appears a more assured return than those with a rental structure.

After-tax analysis would show change in some of the relative value of the returns. Depreciation will raise the value of rental cash flow. Depending on the outcome of tax reform, capital gains special treatment would favor the rental futures over the startup profit and resale income of resident-financing. However, selecting a financing structure for its tax benefits does nothing to resolve the various downside risks. Overall, for the proprietary CCRC developer, with a project of Ashford's characteristics, resident financing most effectively mitigates risks and should provide the largest returns.

Alternative Strategies and Future Directions for Continuing Care

An empirical analysis based on a single project is bound to be colored by the nature of that project. The financial analysis in Chapters 5 and 6 reflects assumptions about Ashford's startup timing, development costs, and operating revenues and expenses. Above all, it reflects Ashford's nature as an expensive, upscale project. All the various financing alternatives, one way or another, are able to make it a profitable project. Much more is needed to ensure success, of course: careful site selection, market analysis, design, marketing, construction cost control, and actuarial prediction, among other factors. Selecting feasible financing is only one part of developing projects as complex as CCRC's. But it is probably the most important part. The case study has illustrated some of the complexities of CCRC's that face the proprietary developer and some of the CCRC characteristics that differ from other residential development. It has briefly indicated how marketing and state regulatory considerations informed development decisions, and shown how one development group has approached the risks of refunds and nursing care. The case has attempted to quantify these risks. Finally, it has analyzed the benefits and risks of three financing and pricing alternatives, and recommended resident financing for this project.

There is a need for further analysis of other risks that are common to most real estate, such as unexpectedly slow absorption. Above all, further study should examine the various risks and returns of profit centers, liabilities and financing methods *interactively*. This paper has used sensitivity analysis to explore the issues in isolation. This is useful to quantify individual cost and profit levels, but not for making development decisions in a working environment.

As an conclusion to the case study, this chapter will discuss development options and financing schemes that could improve the feasibility of continuing care facilities in general.

1. THE NEED TO BUILD A MORE AFFORDABLE PRODUCT AND TO REDUCE OPERATING RISKS

In terms of affordability, Ashford is near the top of the market. Its pricing is appropriate for its location in an affluent part of a city where the market for retirement centers has barely been tapped. If proprietary developers are to penetrate the potential market for retirement centers with any significant impact, however, they must produce and operate them at lower cost. Eventually, they may or may not be able to make retirement centers affordable to a higher percentage of their target market than other newly constructed housing types are *for their* target markets. By seeking solutions for a number of problems they can at least start down that path.

In addition to using financing that costs less, affordability will improve with lower non-financing development and operating costs and risks. Reducing both physical plant costs and operating costs such as nursing will boost affordability. And lowering these costs will in itself attract less-costly financing sources.

Changing Product Configurations. This paper has focussed on continuing care retirement centers with unlimited nursing guarantees. Different product configurations are likely to produce different development and operating profit margins. Some physical changes that may increase affordability for residents (or profitability for developers) are listed below, although they need further analysis.

- Determining the limit to economies of scale, and building at that level
- Increasing nursing center size to offer more economies of scale in nursing and increase its effect as a profit center
- Using phasing to deal with slow absorption
- Adjusting unit mix for more profitable units (eg two- and three-bedrooms), although whether this results in decreased profitability when a community matures (and double occupancy declines) should be studied
- Downsizing units and reducing common-area amenities to lesser, congregate-level standards

Changes involving operations and services center on adjusting the heart of the CCRC: nursing care. Limitation of nursing care is the primary trend in CCRC product configuration today. And a full examination of varied fee structures and their effect on marketability, affordability and developer return is necessary. Two other service provisions may have an effect on costs:

- Using assisted living to reduce nursing care utilization
- Using in-unit assisted and nursing care to avoid full subsidy of temporary patients in assisted units or the nursing center

Reducing Future Liabilities. Eventually, long-term care insurance might assume a key role in boosting affordability of unlimited care facilities, and in the process save the concept from demise in favor of limited care policies. Whether or not the insurance costs less than self-insurance over time, if its price reflects the needs of many beneficiaries in many facilities then it should not be subject to the fluctuations and dramatic increases that self-insurance (in a maturing facility especially) is subject to. These benefits should cover assisted living expenses as well if current policies are indicative of future coverage. Insurance companies might become more involved in financing retirement centers to share in their profitability, and to benefit from the reluctance of some other, even more risk-adverse financial institutions to enter the field. Then it is conceivable that insurance companies would accept increased actuarial risk (ie, lower insurance rates) in return for equity positions in projects. At any rate, if developers use insurance to absorb actuarial risk, which until now has scared off many debt sources or made the rates high for proprietary CCRC's, then they should benefit from more available and less expensive debt. The result will be a more affordable project. Insurance companies have already taken the innovative step of introducing long-term care insurance, and the tremendous need for more complex insurance schemes for CCRC's is likely to continue the initial innovation. Projects with limited nursing liability may become more attractive if residents can individually purchase long-term care insurance. Furthermore, if insurance frees some of the excess resale proceeds from placement in a reserve, these will be available for investor profits in innovative financing structures.

New pricing strategies should also emerge to reduce liability from future refunds. Aside from simply not guaranteeing the refund as at Ashford (which still does not release the facility from liability to the extent funds are available), strategies are possible that reduce the refund rates and still preserve buyers' estates. By letting buyers share in the appreciation of units, lower refund rates are possible with a likely chance of net gain to the resident over the usual flat, static refund rate. For example, with an 80% refund rate and a minimum appreciation of just 1.185% over 10 years, when the buyer shares in appreciation he or she receives a larger refund than with a 90% refund on the original purchase. As noted in Chapter 5, lowering the refund rate dramatically reduces future liability with deflation and, of course, increases resale current income with inflation. Whether giving the buyer effective equity in the unit also entails sharing full downside risks would have to be resolved. Such a scheme also assumes that the excess resale gain given up is not needed for other liabilities such as nursing.

2. NEW FINANCIAL STRATEGIES

Despite the ability for all of the three choices to make Ashford a profitable investment, each has at least nominal drawbacks. And when applied to less luxurious projects, the problems generally increase. More alternatives are needed. Since new financial products develop with a need or opportunity to increase financial returns and resolve obstacles of existing options, CCRC's are ripe for many new financing strategies. So are congregates, but to a lesser extent because they already benefit from several financing options not available to continuing care centers.

Without resident financing, retirement centers generally require low mortgage rates to be economically sound. In the case of using mortgages with a trust, low rates minimize negative arbitrage. With rental projects, as with most rental apartments in the U.S. today, below market rates increase affordability which would otherwise be severely constrained. The problem for retirement centers is that lenders perceive them as highly risky projects and want a compensation for this risk.

One resolution is to insure the debt with credit enhancement and reduce its risk premium. The FHA 221.D insurance program has dramatically promoted the development of rental congregates, increasing their access to tax-exempt and taxable bonds at low rates. Credit enhancement for proprietary CCRC's is far less available; it can be obtained privately but is not common. Credit enhancement is now expensive, reflecting the risk perceived. The savings it brings in a decreased interest rate may not pay for the credit enhancement itself. With development of more proprietary CCRC's, debt insurance for CCRC's, and conceivably rating by Moody's or Standard & Poors, may become more available. This would have an immense effect on debt availability and cost. Rental CCRC's might qualify for credit enhancement with more competitive pricing, implying an unbundling of services. Debt financed by a trust may be the best candidate for credit enhancement, however, since the trust income can be dedicated to debt service as long as the facility operates.

Aside from the need for lower-cost debt obtained through credit enhancement, retirement centers seem appropriate for high-risk participating financing that will accept low guaranteed return in exchange for equity positions. With rental projects, either congregate or CCRC's, this participation could be like almost any of the equity and participating debt structures that abound in commercial and multifamily real estate.

With upfront fee projects, the returns to the participating financing sources would have to be different in nature. Depending on how nursing subsidies are structured, residential cash flow may decline and be a poor source for participating returns. Without fixed debt (or with the debt serviced by a trust and not operating revenues), project cash flow benefits minimally from inflation. If the nursing center has its own mortgage, it does benefit amply from inflation but in absolute terms the nursing center is not a primary profit center. Tax benefits, even to shelter the project's own cash flow, are not available with cooperatives. Thus with upfront fee projects, cash flow and tax benefits are unlikely to attract the participating financing.

The logical form of investors' return in an upfront fee project is from resale activity, which is the CCRC's form of futures. The resale current income

itself---the non-refundable portion of resales---would provide a relatively low return on a significant equity investment (eg, 12-year average of less than 10% with an 80% refund rate and enough equity to lower the debt service one point). With inflation, however, the *excess* resale proceeds can be large. If this money (with or without the resale income) is available and not needed for nursing liability or as resident equity return, it makes a plausible source of funds to secure very high-risk equity. This equity can be used to reduce developer equity or debt service. Alternatively, the resale yield can constitute the participation for debt providing below-market rates on a mortgage. Where equity can be cashed out of a project early, as with resident financing, it should be easy to obtain equity money for the initial expenses that cannot be financed. Yet this involves giving up an almost guaranteed short-term return. Giving up the two kinds of resale return is less of a sacrifice, involving an uncertain, long-term gain. However, the net gain to the developer must be examined more carefully; if resale income and excess proceeds are not needed to fund reserves, then a large amount of the startup profits must be spent on reserves with most product configurations. Structuring participating financing with upfront fee projects will be difficult. Such projects are not necessarily more risky than those which are all-rental, but the latter have the advantage of being a familiar type of fee structure with several sources of revenue for participating financing.

What will be the sources of unsecured, low fixed-cost, participating financing for CCRC's? Banks and savings and loans are unlikely candidates to supply such debt. Insurance companies and pensions may be more forthcoming eventually after they have gained more experience in the field. It may be possible to structure financing with participating, high-risk taxable bonds whose return would largely come from participation in resales or futures. Equity investment funds, such as real estate investment trusts (REIT's) could supply a substantial proportion of a project's financing in conjunction with conventional debt. Bond funds and equity funds may considerably reduce risk by assembling diversified portfolios with facilities balanced by age, type and location.

Low cost debt tied primarily to futures, such as zero coupon bonds and accrual mortgages, are an option for rental projects if they are used in small

enough proportions to be repaid when due. They have to be used with other debt or equity, otherwise the probability that appreciation will fall far behind the interest rate jeopardizes the ability to repay.

A joint venture with a nonprofit organization has a number of benefits for proprietary developers, but tax reform is likely to eliminate most of these. In such arrangements, a proprietary group develops a CCRC and leases it to a non-profit group, which can use its reputation to market the project and which operates it. The proprietary group receives tax benefits in the early years using accelerated depreciation. It later sells the facility to the non-profit group which, by retaining the operating profits and resale proceeds, may be in a position to buy. The proprietary group finances the project with equity and with debt secured by income from a trust of entrance fees. This arrangement is unlikely to be feasible for proprietary developers after tax reform, but liaisons with non-profit groups will continue to be important in obtaining certification and nursing care licenses, credibility for marketing, and especially well-situated land at low cost. Also, proprietary developers can act as development agents for non-profits with or without equity positions. Without equity, income would come from development fees (which may be up to 10% of project costs), construction fees, marketing commissions and management contracts. For proprietary developers with expertise who wish to reduce risk in exchange for a smaller return, this structure can be ideal.

3. THE POTENTIAL OF THE INDUSTRY

As development of proprietary CCRC's and congregate projects rises, new financial products and techniques will undoubtedly be in company. The nature of some of the entrants to the industry will encourage financial inventiveness. They may mix corporate finance practices with real estate. Marriott Corporation, for example, will draw on an unrestricted corporate line of credit to finance construction of its lifecare projects at rates below conventional construction financing, and may decide to continue servicing the original debt indefinitely, rather than using entrances fees as a take out or securing permanent debt, depending on rates when development is complete. Some entrants will go directly to the capital markets to secure financing.

Oxford Development has arranged \$300 million in tax-exempt limited partnerships for financing its congregate centers. These will provide participating tax-exempt debt. As competitors in the retirement center industry, large firms will find it easiest to secure low cost debt, to survive long startup periods and to assemble risk-balanced portfolios. They will be able to use non-project-specific financing (eg, Marriott's line of credit) when it provides lower rates.

For the small developer without these advantages, it is currently simpler to finance congregates than CCRC's. Congregates benefit from less risk because the nursing care and refund liabilities, financing sources accept the fee structure and credit enhancement is readily available.

The potential for the industry appears excellent over the long term, for developers who can absorb the downside risks if they materialize. More product and financing experimentation is likely to produce highly profitable models for development. While the market may be small now (and never large), few real estate products are assured of growth while in their infancy. To realize their potential, new financing sources to make continuing care communities more affordable are needed---and therefore likely to emerge.

Appendix

APPENDIX TABLE 1: ASHFORD SPACE ANALYSIS

	NUMBER	% TYPE	% TOTAL	SQ FT	TOTAL SQ FT	% TOTAL
<i>INDEPENDENT UNITS:</i>						
ILU STUDIO	0	0%	0%	0	0	
ILU 1 BR A	60	22%	20%	625	37,500	
ILU 1 BR B	75	28%	25%	775	58,125	
ILU 2 BR A	75	28%	25%	950	71,250	
ILU 2 BR B	60	22%	20%	1,100	66,000	
	270				232,875	
<i>ASSISTED UNITS:</i>						
ALU STUDIC	30	100%	10%	450	13,500	
ALU 1 BR	0	0%	0%	0	0	
	30				13,500	
TOTAL UNIT	300				246,375	74%
CIRCULATION @ 20%					49,275	15%
					295,650	89%
<i>COMMON AREA:</i>				<u>SQ FT</u>		
LOBBIES/ENTRY LOUNGES				4,500		
OTHER LOUNGES				1,000		
LIBRARY				400		
CLUB				200		
CONFERENCE				200		
AUDITORIUM				2,000		
SNACK BAR/STORE				400		
BEAUTY/BARBER				250		
CRAFTS				250		
EXERCISE/JACUZZI CENTER				1,000		
GUEST ROOMS (2@300)				600		
OFFICES				1,000		
NURSE/EXAM				250		
RESIDENT SERVICES				1,200		
DINING ROOM (@12 SQ FT PP)				4,500		
PRIVATE DINING				300		
KITCHEN				2,400		
HOUSEKEEPING/MAIN/STORAGE				3,500		
LAUNDRIES (5@400)				2,000		
UNIT STOR (@30 SQ FT, 50% NET)				4,500		
TOTAL				30,450	30,450	9%
CIRCULATION @ 20%					6,090	2%
					36,540	11%
TOTAL					332,190	100%
BALCONIES (@50 SQ FT/UNIT, 80% UNITS, @75% NET SINCE \$45/SQ FT)					9,000	

**APPENDIX TABLE 2: ASHFORD DEVELOPMENT COSTS
(RESIDENT FINANCING ALTERNATIVE)**

	<u>TOTAL COST</u>	<u>COST/UNIT</u>	<u>% TOTAL</u>
<i>LAND:</i>	1,600,000	5,333	4.2%
<i>HARD COSTS:</i>			
1 CONSTRUCTION	19,931,400	66,438	52.4%
2 BALCONIES	540,000	1,800	1.4%
3 SITE IMPROVEMENTS	3,475,000	11,583	9.1%
4 NURSING HOME TOTAL	2,485,000	8,283	6.5%
	<u>26,431,400</u>	<u>88,105</u>	<u>69.5%</u>
<i>SOFT COSTS:</i>			
5 A&E	1,585,884	5,286	4.2%
6 CONSULTANTS	100,000	333	0.3%
7 LEGAL	435,000	1,450	1.1%
8 PERMITS	100,000	333	0.3%
9 FFE	850,000	2,833	2.2%
10 RE TAXES	500,000	1,667	1.3%
11 MARKETING	1,500,000	5,000	3.9%
12 MISC SOFT	50,000	167	0.1%
13 CONST INTEREST	2,613,600	8,712	6.9%
14 ORIGINATION	67,095	224	0.2%
	<u>7,801,579</u>	<u>26,005</u>	<u>20.5%</u>
<i>SUBTOTAL</i>	35,832,979	119,443	94.3%
15 DEVELOPMENT FEE	1,074,989	3,583	2.8%
16 CONTINGENCY	1,107,239	3,691	2.9%
17 <i>TOTAL DEV COST</i>	<u>38,015,207</u>	<u>126,717</u>	<u>100.0%</u>

NOTES:

- 2 Calculated separately to void square foot count in operating expenses
- 11 5,000 per unit
- 13 Construction financing based on 33% average draw over 24 months (36,000,000 loan amount)
- 14 Origination fee for nursing home mortgage
- 16 Contingency is relatively low percentage because it is based on entire cost

APPENDIX TABLE 3: ASHFORD EXPENSES

<i>STAFFING:</i>	FTE	WAGE	ANNUAL/PP	ANNUAL
ADMINISTRATION:				
ADMINISTRATOR	1.0		45,000	45,000
MARKETING DIR	1.0		25,000	25,000
ACTIVITIES DIR	1.0		20,000	20,000
RECEPTION	2.0	\$6.50	13,520	27,040
SECRETARY	1.0	\$7.50	15,600	15,600
BOOKEEPER	1.0	\$8.00	16,640	16,640
SECURITY	4.2	\$6.00	12,480	52,416
PERSONAL AIDES	6.0	\$6.00	12,480	74,880
PHYSICAL REHAB	1.0	\$8.00	16,640	16,640
	18.2			293,216
HOUSEKEEPING:				
SUPERVISOR	3.0	\$8.00	16,640	49,920
HOUSEKEEPERS	7.0	\$6.00	12,480	87,360
JANITOR	2.0	\$6.50	13,520	27,040
ROVING HELPERS	3.5	\$6.00	12,480	43,680
LAUNDRY AIDE	1.0	\$6.00	12,480	12,480
	16.5			220,480
MAINTENANCE:				
SUPERVISOR	1.0		25,000	25,000
GROUNDSPERSON	3.0	\$6.00	12,480	37,440
DRIVER	2.0	\$6.00	12,480	24,960
	6.0			87,400
PAYROLL	40.7			601,096
BENEFITS @	20.0%			120,219
TOTAL STAFFING				721,315
PER UNIT/MONTH				200
OPERATING:				
REAL ESTATE TAXE	PRICE/UNIT		NO. UNITS	TOTAL
	\$2.00 /SQ FT		332,190	664,380
UTILITIES	\$1.50 /SQ FT		332,190	498,285
INSURANCE	\$0.20 /SQ FT		332,190	66,438
MISCELLANEOUS	\$1.40 /PP/DAY		136,875	191,625
MANAGEMENT FEE	6.0%		4,410,000	264,600
TOTAL				1,685,328
PER UNIT/MONTH				468
DIETARY:				
TOTAL DIETARY	\$6.00 /PP/DAY		136,875	821,250
PER UNIT/MONTH				228
TOTAL (EXC NURSING SUBSIDY AND RESERVE):				
TOTAL				3,227,893
TOTAL PER UNIT/MONTH				897
AVERAGE RENT/MONTH				1,215

**APPENDIX TABLE 5: FINANCING DATA
TRUST/MORTGAGE FINANCING WITH 0% ARBITRAGE**

FINANCING:

CONSTRUCTION FINANCING:

AMOUNT	\$36,000,000
CONST INT RATE	11.00%
AVER OUTSTAND.	33.0%
CONST PERIOD	24 MOS
CONST POINTS	0.0%

PERMANENT FINANCING:

<u>SOURCE:</u>	<u>AMOUNT</u>	<u>FEE</u>	<u>AMORT</u>	<u>RATE</u>	<u>PAYMENT</u>	<u>COMMENTS</u>
1. NURS. HOME MTG	2,236,500	3.0%	30	11.0%	(255,585)	90% LTV
2. CCRC MTG	36,660,000	3.0%	30	8.0%	(3,227,977)	

0.0%

EQUITY FINANCING:

<u>SOURCE:</u>	<u>AMOUNT</u>	<u>PRIORITY</u>	<u>TERM YMENT</u>	<u>COMMENTS</u>
3. SALES	285,485			FUNDS DEVELOPMENT DEFICIT
4. SALES	43,199,515			ASSIGNED TO TRUST
5. SALES	1,000,000			ASSIGNED TO SHORT TERM RESERVE
6. SALES	1,340,000			DEV START UP PROFITS
TOTAL SALES	45,825,000			

APPENDIX TABLE 5: TRUST/MORTGAGE FINANCING WITH 0% ARBITRAGE---PROJECTED RESIDENTIAL OPERATIONS BEFORE TAX CASH FLOW

YEAR:	VACANCY RATE	1	2	3	4	5	6	7	8	9	10	11	12
INCOME:													
1	ILU'S	0.0%	3,519,000	3,519,000	3,519,000	3,519,000	3,519,000	3,519,000	3,519,000	3,519,000	3,519,000	3,519,000	3,519,000
2	ALU'S	0.0%	540,000	540,000	540,000	540,000	540,000	540,000	540,000	540,000	540,000	540,000	540,000
			4,059,000	4,059,000	4,059,000	4,059,000	4,059,000	4,059,000	4,059,000	4,059,000	4,059,000	4,059,000	4,059,000
3	DOUBLE OCCUP	0.0%	315,000	315,000	315,000	315,000	315,000	315,000	315,000	315,000	315,000	315,000	315,000
4	SERVICE FEE	0.0%	0	0	0	0	0	0	0	0	0	0	0
5	MISC INCOME	0.0%	36,000	36,000	36,000	36,000	36,000	36,000	36,000	36,000	36,000	36,000	36,000
			351,000	351,000	351,000	351,000	351,000	351,000	351,000	351,000	351,000	351,000	351,000
6	POTENTIAL OPERATING F		4,410,000	4,410,000	4,410,000	4,410,000	4,410,000	4,410,000	4,410,000	4,410,000	4,410,000	4,410,000	4,410,000
7	VACANCY		70.0%	22.5%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
8	LESS VACANCY		(3,087,000)	(992,250)	(220,500)	(220,500)	(220,500)	(220,500)	(220,500)	(220,500)	(220,500)	(220,500)	(220,500)
9	EFFECTIVE OPERATING F		1,323,000	3,417,750	4,189,500	4,189,500	4,189,500	4,189,500	4,189,500	4,189,500	4,189,500	4,189,500	4,189,500
10	INTEREST INCOME		0	523,161	3,535,961	3,535,961	3,535,961	3,535,961	3,535,961	3,535,961	3,535,961	3,535,961	3,535,961
11	TOTAL REVENUE		1,323,000	3,940,911	7,725,461	7,725,461	7,725,461	7,725,461	7,725,461	7,725,461	7,725,461	7,725,461	7,725,461
EXPENSES:													
12	NURSING SUBSIDY		(297,327)	(339,204)	(381,081)	(422,958)	(464,835)	(506,712)	(548,589)	(590,466)	(632,343)	(674,220)	(716,097)
13	PLUS VACANCY		208,129	76,321	19,054	21,148	23,242	25,336	27,429	29,523	31,617	33,711	35,805
14	STAFFING	0.0%	(432,789)	(721,315)	(721,315)	(721,315)	(721,315)	(721,315)	(721,315)	(721,315)	(721,315)	(721,315)	(721,315)
15	OPERATING	0.0%	(1,685,328)	(1,685,328)	(1,685,328)	(1,685,328)	(1,685,328)	(1,685,328)	(1,685,328)	(1,685,328)	(1,685,328)	(1,685,328)	(1,685,328)
16	PLUS VACANCY		438,019	59,535	13,230	13,230	13,230	13,230	13,230	13,230	13,230	13,230	13,230
17	DIETARY	0.0%	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)
18	PLUS VACANCY		574,875	184,781	41,063	41,063	41,063	41,063	41,063	41,063	41,063	41,063	41,063
19	TOTAL OPERATING EXPE		(2,015,671)	(3,246,460)	(3,535,627)	(3,575,411)	(3,615,194)	(3,654,977)	(3,694,760)	(3,734,543)	(3,774,326)	(3,814,109)	(3,853,893)
20	REPLACE. RESE	1.50%	(66,150)	(66,150)	(66,150)	(66,150)	(66,150)	(66,150)	(66,150)	(66,150)	(66,150)	(66,150)	(66,150)
21	NET OPERATING INCOME		(758,821)	628,301	4,123,684	4,083,901	4,044,118	4,004,334	3,964,551	3,924,768	3,884,985	3,845,202	3,805,419
22	DEBT SERVICE			(3,227,977)	(3,227,977)	(3,227,977)	(3,227,977)	(3,227,977)	(3,227,977)	(3,227,977)	(3,227,977)	(3,227,977)	(3,227,977)
23	PARTICIPATION												
24	BEFORE TAX CASH FLOW		(758,821)	628,301	895,707	855,924	816,140	776,357	736,574	696,791	657,008	617,225	577,442

NOTES:

- 3 Figured at average double occupancy rate stated in assumptions. Actual rate would decline as community matures.
- 10 Total of reserve and trust income shown in TABLE 4.
- 12 From nursing subsidy in table TABLE 5. Also assumed equal to insurance premium if long term care insurance premium used.
- 13 Based on vacancy rate in Line 7
- 14 Staffing Year 1 only adjusted for vacancy (load of twice occupancy rate)
- 16 Vacancy on management fee only, except Year 1 where also adjusted for 50% of occupancy
- 18 Based on vacancy rate in Line 7
- 20 Figured on potential operating revenue

**APPENDIX TABLE 6: TRUST/MORTGAGE FINANCING
WITH 0% ARBITRAGE---EQUITY REQUIREMENTS (in 000's)**

1	TOTAL SALES	45,825			
2	TOTAL DEVELOPMENT	<u>(39,182)</u>			
3	GROSS PROFIT	6,643	14.5%		
4	LESS RESERVE	(1,000)			
5	NET BUILDING PROFIT	5,643			
	ACTIVITY:	START UP	CONSTONST/OPER	OPER	
	YEAR:		1	2	
6	START UP FUND	(375)			
7	LAND	(1,600)			
8	PRECONSTRUCTION COSTS	(1,700)			
9	MARKETING	(375)	(375)	(375)	(375)
10	REMAINING DEVELOPMENT COSTS	<u>(4,050)</u>	<u>(17,003)</u>	<u>(17,003)</u>	
11	RESERVE				(1,000)
12	SALES			22,913	22,913
13	SURPLUS (DEFICIT)	(4,050)	(17,378)	5,534	21,538
14	CONST FINANCING RECEIVED	0	17,378		
	CONST FINANCING PAID:				
15	WITH SURPLUS			(5,534)	(9,608)
16	WITH PERMANENT FINANCING			(2,237)	
17	CONST FINANCING OUTSTANDING		(17,378)	(9,608)	0
18	PERMANENT FINANCING RECEIVED			(2,237)	36,660
19	DEVELOPER START UP PAYMENT				(1,340)
20	DEVELOPER EQUITY RETURN				(4,050)
21	ASSIGNED TO TRUST FROM SALES				(6,540)
22	ASSIGNED TO TRUST FROM CCRC MTG				(36,660)
23	PERMANENT FINANCING DUE			2,237	(34,424)
24	DEVELOPMENT CASH FLOW	(4,050)	0	0	5,390
25	OPERATIONS CASH FLOW			(830)	741
26	EQUITY REQUIRED	<u>(4,050)</u>	0	(830)	6,131
27	CUMMULATIVE	(4,050)	(4,050)	(4,880)	1,251

NOTES:

- 2 Does not include operating deficit
- 10 Total development costs less all costs in lines 6-9
- 14 Assumes full coverage
- 21 Begins earning interest Year 2
- 22 Begins earning interest Year 3
- 25 From TABLE 7

APPENDIX TABLE 7: TRUST/MORTGAGE FINANCING FINANCING DATA

CONSTRUCTION FINANCING:

AMOUNT	\$36,000,000
CONST INT RATE	11.00%
AVER OUTSTAND.	33.0%
CONST PERIOD	24 MOS
CONST POINTS	0.0%

PERMANENT FINANCING:

<u>SOURCE:</u>	<u>AMOUNT</u>	<u>FEE AMORT</u>	<u>RATE</u>	<u>PAYMENT</u>	<u>COMMENTS</u>
1. NURS. HOME M.	2,236,500	3.0% 30	11.0%	(255,585)	90% LTV
2. CCRC MTG	22,132,793	3.0% 30	10.0%	(2,330,773)	

2.0%

EQUITY FINANCING:

<u>SOURCE:</u>	<u>AMOUNT</u>	<u>COMMENTS</u>
3. SALES	14,350,335	FUNDS DEVELOPMENT DEFICIT
4. SALES	29,134,665	ASSIGNED TO TRUST
5. SALES	1,000,000	ASSIGNED TO SHORT TERM RESERVE
6. SALES	1,340,000	DEV START UP PROFITS
TOTAL SALES	45,825,000	

APPENDIX TABLE 8: TRUST/MORTGAGE FINANCING WITH 2% ARBITRAGE---PROJECTED RESIDENTIAL OPERATIONS BEFORE TAX CASH FLOW

YEAR:	NFLATION	1	2	3	4	5	6	7	8	9	10	11	12
INCOME:													
1	ILU'S	0.0%	3,519,000	3,519,000	3,519,000	3,519,000	3,519,000	3,519,000	3,519,000	3,519,000	3,519,000	3,519,000	3,519,000
2	ALU'S	0.0%	540,000	540,000	540,000	540,000	540,000	540,000	540,000	540,000	540,000	540,000	540,000
			4,059,000	4,059,000	4,059,000	4,059,000	4,059,000	4,059,000	4,059,000	4,059,000	4,059,000	4,059,000	4,059,000
3	DOUBLE OCCU.	0.0%	315,000	315,000	315,000	315,000	315,000	315,000	315,000	315,000	315,000	315,000	315,000
4	SERVICE FEE	0.0%	0	0	0	0	0	0	0	0	0	0	0
5	MISC INCOME	0.0%	36,000	36,000	36,000	36,000	36,000	36,000	36,000	36,000	36,000	36,000	36,000
			351,000	351,000	351,000	351,000	351,000	351,000	351,000	351,000	351,000	351,000	351,000
6	POTENTIAL OPERATING RE		4,410,000	4,410,000	4,410,000	4,410,000	4,410,000	4,410,000	4,410,000	4,410,000	4,410,000	4,410,000	4,410,000
7	VACANCY		70.0%	22.5%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
8	LESS VACANCY		(3,087,000)	(992,250)	(220,500)	(220,500)	(220,500)	(220,500)	(220,500)	(220,500)	(220,500)	(220,500)	(220,500)
9	EFFECTIVE OPERATING RE		1,323,000	3,417,750	4,189,500	4,189,500	4,189,500	4,189,500	4,189,500	4,189,500	4,189,500	4,189,500	4,189,500
10	INTEREST INCOME		0	560,150	2,410,773	2,410,773	2,410,773	2,410,773	2,410,773	2,410,773	2,410,773	2,410,773	2,410,773
11	TOTAL REVENUE		1,323,000	3,977,900	6,600,273	6,600,273	6,600,273	6,600,273	6,600,273	6,600,273	6,600,273	6,600,273	6,600,273
EXPENSES:													
12	NURSING SUBSIDY		(297,327)	(339,204)	(381,081)	(422,958)	(464,835)	(506,712)	(548,589)	(590,466)	(632,343)	(674,220)	(716,097)
13	PLUS VACANCY		208,129	76,321	19,054	21,148	23,242	25,336	27,429	29,523	31,617	33,711	35,805
14	STAFFING	0.0%	(432,789)	(721,315)	(721,315)	(721,315)	(721,315)	(721,315)	(721,315)	(721,315)	(721,315)	(721,315)	(721,315)
15	OPERATING	0.0%	(1,685,328)	(1,685,328)	(1,685,328)	(1,685,328)	(1,685,328)	(1,685,328)	(1,685,328)	(1,685,328)	(1,685,328)	(1,685,328)	(1,685,328)
16	PLUS VACANCY		438,019	59,535	13,230	13,230	13,230	13,230	13,230	13,230	13,230	13,230	13,230
17	DIETARY	0.0%	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)
18	PLUS VACANCY		574,875	184,781	41,063	41,063	41,063	41,063	41,063	41,063	41,063	41,063	41,063
19	TOTAL OPERATING EXPEN		(2,015,671)	(3,246,460)	(3,535,627)	(3,575,411)	(3,615,194)	(3,654,977)	(3,694,760)	(3,734,543)	(3,774,326)	(3,814,109)	(3,853,893)
20	REPLACE. RESF	1.50%	(66,150)	(66,150)	(66,150)	(66,150)	(66,150)	(66,150)	(66,150)	(66,150)	(66,150)	(66,150)	(66,150)
21	NET OPERATING INCOME		(758,821)	665,290	2,998,496	2,958,713	2,918,930	2,879,146	2,839,363	2,799,580	2,759,797	2,720,014	2,680,231
22	DEBT SERVICE				(2,330,773)	(2,330,773)	(2,330,773)	(2,330,773)	(2,330,773)	(2,330,773)	(2,330,773)	(2,330,773)	(2,330,773)
23	PARTICIPATION												
24	BEFORE TAX CASH FLOW		(758,821)	665,290	667,723	627,940	588,156	548,373	508,590	468,807	429,024	389,241	349,457

NOTES:

- 3 Figured at average double occupancy rate stated in assumptions. Actual rate would decline as community matures.
- 10 Total of reserve and trust income shown in TABLE 4.
- 12 From nursing subsidy in table TABLE 5. Also assumed equal to insurance premium if long term care insurance premium used.
- 13 Based on vacancy rate in Line 7
- 14 Staffing Year 1 only adjusted for vacancy (load of twice occupancy rate)
- 16 Vacancy on management fee only, except Year 1 where also adjusted for 50% of occupancy
- 18 Based on vacancy rate in Line 7
- 20 Figured on potential operating revenue

**APPENDIX TABLE 9: TRUST/MORTGAGE FINANCING
WITH 2% ARBITRAGE---EQUITY REQUIREMENTS (in 000's)**

1	TOTAL SALES	45,825			
2	TOTAL DEVELOPMENT	<u>(38,720)</u>			
3	GROSS PROFIT	7,105	15.5%		
4	LESS RESERVE	(1,000)			
5	NET BUILDING PROFIT	6,105			
	ACTIVITY:	START UP	CONSTONST/OPER	OPER	
	YEAR:		1	2	
6	START UP FUND	(375)			
7	LAND	(1,600)			
8	PRECONSTRUCTION COSTS	(1,700)			
9	MARKETING	(375)	(375)	(375)	(375)
10	REMAINING DEVELOPMENT COSTS	<u>(4,050)</u>	<u>(16,772)</u>	<u>(16,772)</u>	<u>(375)</u>
11	RESERVE				(1,000)
12	SALES			22,913	22,913
13	SURPLUS (DEFICIT)	(4,050)	(17,147)	5,765	21,538
14	CONST FINANCING RECEIVED	0	17,147		
	CONST FINANCING PAID:				
15	WITH SURPLUS			(5,765)	(9,146)
16	WITH PERMANENT FINANCING			(2,237)	
17	CONST FINANCING DUE		(17,147)	(9,146)	0
18	PERMANENT FINANCING RECEIVED			(2,237)	22,133
19	DEVELOPER START UP PAYMENT				(1,340)
20	DEVELOPER EQUITY RETURN				(4,050)
21	ASSIGNED TO TRUST FROM SALES				(7,002)
22	ASSIGNED TO TRUST FROM CCRC MTG				(22,133)
23	PERMANENT FINANCING DUE			2,237	(19,896)
24	DEVELOPMENT CASH FLOW	(4,050)	0	0	5,390
25	OPERATIONS CASH FLOW			(830)	778
26	EQUITY REQUIRED	<u>(4,050)</u>	0	(830)	6,168
27	CUMMULATIVE	(4,050)	(4,050)	(4,880)	1,288

NOTES:

- 2 Does not include operating deficit
- 10 Total development costs less all costs in lines 6-9
- 14 Assumes full coverage
- 21 Begins earning interest Year 2
- 22 Begins earning interest Year 3
- 25 From TABLE 7

APPENDIX TABLE 10: ALL-RENTAL STRUCTURE---PROJECTED RESIDENTIAL OPERATIONS BEFORE TAX CASH FLOW

YEAR:	FLATION	1	2	3	4	5	6	7	8	9	10	11	12
INCOME:													
1	ILU'S	0.0%	7,180,200	7,180,200	7,180,200	7,180,200	7,180,200	7,180,200	7,180,200	7,180,200	7,180,200	7,180,200	7,180,200
2	ALU'S	0.0%	946,800	946,800	946,800	946,800	946,800	946,800	946,800	946,800	946,800	946,800	946,800
			8,127,000	8,127,000	8,127,000	8,127,000	8,127,000	8,127,000	8,127,000	8,127,000	8,127,000	8,127,000	8,127,000
3	DOUBLE OCCUPANCY	0.0%	315,000	315,000	315,000	315,000	315,000	315,000	315,000	315,000	315,000	315,000	315,000
4	SERVICE FEE	0.0%	0	0	0	0	0	0	0	0	0	0	0
5	MISC INCOME	0.0%	36,000	36,000	36,000	36,000	36,000	36,000	36,000	36,000	36,000	36,000	36,000
			351,000	351,000	351,000	351,000	351,000	351,000	351,000	351,000	351,000	351,000	351,000
6	POTENTIAL OPERATING REVENUE		8,478,000	8,478,000	8,478,000	8,478,000	8,478,000	8,478,000	8,478,000	8,478,000	8,478,000	8,478,000	8,478,000
7	VACANCY		70.0%	22.5%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%	5.0%
8	LESS VACANCY		(5,934,600)	(1,907,550)	(423,900)	(423,900)	(423,900)	(423,900)	(423,900)	(423,900)	(423,900)	(423,900)	(423,900)
9	EFFECTIVE OPERATING REVENUE		2,543,400	6,570,450	8,054,100	8,054,100	8,054,100	8,054,100	8,054,100	8,054,100	8,054,100	8,054,100	8,054,100
10	INTEREST INCOME		40,000	80,000	80,000	80,000	80,000	80,000	80,000	80,000	80,000	80,000	80,000
11	TOTAL REVENUE		2,583,400	6,650,450	8,134,100	8,134,100	8,134,100	8,134,100	8,134,100	8,134,100	8,134,100	8,134,100	8,134,100
EXPENSES:													
12	NURSING SUBSIDY		(297,327)	(339,204)	(381,081)	(422,958)	(464,835)	(506,712)	(548,589)	(590,466)	(632,343)	(674,220)	(716,097)
13	PLUS VACANCY		208,129	76,321	19,054	21,148	23,242	25,336	27,429	29,523	31,617	33,711	35,805
14	STAFFING	0.0%	(432,789)	(721,315)	(721,315)	(721,315)	(721,315)	(721,315)	(721,315)	(721,315)	(721,315)	(721,315)	(721,315)
15	OPERATING	0.0%	(1,697,771)	(1,697,771)	(1,697,771)	(1,697,771)	(1,697,771)	(1,697,771)	(1,697,771)	(1,697,771)	(1,697,771)	(1,697,771)	(1,697,771)
16	PLUS VACANCY		610,742	114,453	25,434	25,434	25,434	25,434	25,434	25,434	25,434	25,434	25,434
17	DIETARY	0.0%	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)	(821,250)
18	PLUS VACANCY		574,875	184,781	41,063	41,063	41,063	41,063	41,063	41,063	41,063	41,063	41,063
19	TOTAL OPERATING EXPENSES		(1,855,392)	(3,203,985)	(3,535,867)	(3,575,650)	(3,615,433)	(3,655,216)	(3,694,999)	(3,734,782)	(3,774,565)	(3,814,349)	(3,854,132)
20	REPLACE. RESERVE @	1.50%	(69,261)	(69,261)	(69,261)	(69,261)	(69,261)	(69,261)	(69,261)	(69,261)	(69,261)	(69,261)	(69,261)
21	NET OPERATING INCOME		658,748	3,377,204	4,528,973	4,489,189	4,449,406	4,409,623	4,369,840	4,330,057	4,290,274	4,250,491	4,210,707
22	DEBT SERVICE		(1,930,306)	(3,860,613)	(3,860,613)	(3,860,613)	(3,860,613)	(3,860,613)	(3,860,613)	(3,860,613)	(3,860,613)	(3,860,613)	(3,860,613)
23	DEBT COVERAGE RATIO				1.17	1.16	1.15	1.14	1.13	1.12	1.11	1.10	1.09
24	BEFORE TAX CASH FLOW		(1,271,559)	(483,409)	668,361	628,578	588,795	549,011	509,228	469,445	429,662	389,879	350,096

NOTES:

- 3 Figured at average double occupancy rate stated in assumptions. Actual rate would decline as community matures.
- 10 Total of reserve and trust income shown in TABLE 4.
- 12 From nursing subsidy in table TABLE 5. Also assumed equal to insurance premium if long term care insurance premium used.
- 13 Based on vacancy rate in Line 7
- 14 Staffing Year 1 only adjusted for vacancy (load of twice occupancy rate)
- 16 Vacancy on management fee only, except Year 1 where also adjusted for 50% of occupancy
- 18 Based on vacancy rate in Line 7
- 20 Figured on potential operating revenue less debt service

**APPENDIX TABLE 11: ALL-RENTAL STRUCTURE---
EQUITY REQUIREMENTS (in 000's)**

4	LESS RESERVE	(1,000)			
	ACTIVITY:	START UP	CONSTONST/OPER	OPER	
	YEAR:		1	2	
6	START UP FUND	(375)			
7	LAND	(1,600)			
8	PRECONSTRUCTION CO	(1,700)			
9	MARKETING	(375)	(375)	(375)	(375)
10	REMAINING DEVELOPMENT COSTS	(4,050)	(17,206)	(17,206)	
			(17,581)	(17,581)	(375)
11	RESERVE			(1,000)	
12	SALES			0	0
13	SURPLUS (DEFICIT)	(4,050)	(17,581)	(18,581)	(375)
14	CONST FINANCING REI	0	17,581	18,581	
	CONST FINANCING PAID:		36,162		
15	WITH SURPLUS			0	0
16	WITH PERMANENT FINANCING			(38,897)	0
17	CONST FINANCING OUTSTANDING		(17,581)	0	0
18	PERMANENT FINANCING RECEIVED			38,897	0
19	PERMANENT FINANCING DUE			(38,897)	0
20	DEVELOPMENT CASH F	(4,050)	0	2,734	(375)
21	OPERATIONS CASH FLOW			(1,342)	(417)
22	EQUITY REQUIRED	(4,050)	0	1,392	(792)
23	CUMMULATIVE	(4,050)	(4,050)	(2,658)	(3,450)

NOTES:

- 2 Does not include operating deficit
- 10 Total development costs less all costs in lines 6-9
- 14 Assumes full coverage
- 21 From TABLE 9

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